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Audits of fire and casualty insurance companies (1982); Industry audit guide: Audit and accounting guide

American Institute of Certified Public Accountants. Committee on Insurance Accounting and Auditing

AICPA
American Institute of Certified Public Accountants

INDUSTRY AUDIT GUIDE

AUDITS OF FIRE AND CASUALTY INSURANCE COMPANIES

PREPARED BY THE COMMITTEE ON INSURANCE ACCOUNTING AND AUDITING

Fourth Edition

Including
STATEMENTS OF POSITION
ISSUED BY THE AUDITING STANDARDS DIVISION
and
STATEMENT OF FINANCIAL ACCOUNTING STANDARDS
ISSUED BY THE FINANCIAL ACCOUNTING STANDARDS BOARD

Note: This volume includes the industry audit guide, *Audits of Fire and Casualty Insurance Companies,* as it was originally published in 1966; the statement of position, *Revision of Form of Auditor's Report: Audits of Fire and Casualty Insurance Companies,* issued by the auditing standards division in 1974; and Statement of Position 78-6, *Accounting for Property and Liability Insurance Companies,* issued by the accounting standards division in 1978. In using this guide, readers should refer to the additional material in the statements of position (pages 79-114), which was not available when the guide was issued.

Douglas R. Carmichael
Vice President—Auditing

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NOTICE TO READERS OF FOURTH EDITION

This volume includes

- *Audits of Fire and Casualty Insurance Companies*, the industry audit guide as it was originally published in 1966.
- *Revision of Form of Auditor's Report: Audits of Fire and Casualty Insurance Companies*, a statement of position issued by the auditing standards division in 1974 (Appendix A).
- *Auditing Property and Liability Reinsurance*, a statement of position issued by the auditing standards division in 1982 (Appendix B).
- *Accounting and Reporting by Insurance Enterprises*, Statement of Financial Accounting Standards No. 60, issued by the Financial Accounting Standards Board in 1982 (Appendix C).

In using this guide, readers should refer to the additional material in the appendixes, which was not available when the original guide was issued.

This audit guide presents recommendations of the 1965–66 AICPA Committee on Insurance Accounting and Auditing regarding application of generally accepted auditing standards to audits of financial statements of fire and casualty insurance companies (now generally referred to as property and liability insurance companies). It represents the considered opinion of that committee on the best auditing practice in the industry. The auditing statements of position included in this volume represent the considered opinion of the responsible AICPA task forces on the best auditing practice in the industry and have been reviewed by the auditing standards division for consistency with auditing standards existing at the time the statements were published. AICPA members may have to justify departures from the recommendations in this guide and the related statements if their work is challenged.

FASB Statement No. 60 extracted the specialized accounting principles and practices described in this audit guide, in Statement of Position 78-6, *Accounting for Property and Liability Insurance Companies*, and other AICPA guides and statements of position relating to accounting by insurance enterprises. Pronouncements of the FASB are enforceable under Rule 203 of the AICPA Code of Professional Ethics.

October 1982

D. R. Carmichael
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NOTICE TO READERS

This bulletin is published for the information and assistance of members of the Institute and others interested in the subject. It presents the view of the members of the 1965-66 committee on insurance accounting and auditing. Since it has not been considered and acted upon by the Council of the Institute, it does not represent an official position of the Institute.

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Preface

This booklet has been prepared for the purpose of broadening the knowledge of the independent auditor regarding those aspects of the fire and casualty insurance business which he should be aware of in order to most effectively serve his clients in that industry.

The material contained in this booklet covers such matters as the nature of the business and how it is conducted; the character and extent of regulation and its effect upon company policies and practices; the methods and mechanics of accounting and record keeping for major types of transactions and classifications of accounts; the prescribed financial reporting principles and practices and their variances from generally accepted accounting principles for business in general; basic forms of financial statements; and the independent auditor's report.

The booklet includes suggested auditing procedures designed to provide a pattern of the work to be done; they are, therefore, very general in nature and will not apply in the same degree to all situations. The program for each audit should be designed to meet the requirements of the particular situation, giving careful consideration to the size, the type of organization and the adequacy of the existing system of internal control.

Committee on Insurance Accounting and Auditing

July 1966

Chapter I

NATURE AND CONDUCT OF BUSINESS

General Nature of the Business

The primary purpose of the fire and casualty insurance business is spreading of risks. For a consideration known as a premium, insurance companies undertake to relieve the policyholder of a risk and to spread the total cost of similar risks among large groups of policyholders. The fire and casualty insurance business includes the sale of insurance, the underwriting operation (i.e., the determination of the acceptability of the risk and the premium), the collection of premiums and investigation and settlement of claims made under the policies issued.

In the process of conducting its business an insurance company accumulates large sums of money. These funds represent an accumulation of premiums collected in advance for periods, generally for one to five years, and sums held for the payment of claims in process of investigation, adjustment, or litigation. The possession of these funds leads to the second major operation, the investment of funds.

The hazards insured are generally grouped into what are known as lines of insurance, as follows: fire and allied lines, ocean and inland marine, commercial and homeowners multiple perils, accident and health, workmen's compensation, general liability, automobile liability and physical damage, fidelity and surety, glass, burglary and theft, and boiler and machinery.

All of these lines of insurance may be written in the same company if it qualifies for multiple line writing of insurance.

Types of Organization

The following are the principal types of organization:

Stock companies:

A stock company is an ordinary corporation organized for profit; ownership of assets and control of operations are vested in the stockholders. Generally the stockholders are not liable in case of bankruptcy or impairment of capital.

Mutual companies:

A mutual company is an organization in which the ownership of assets and control of operations are vested in policyholders having ownership rights only as long as they continue being policyholders; upon the expiration of their policies, they lose all rights and interest in the company. In many states upon liquidation of a mutual insurance company, the net assets are distributed among the then policyholders of the company and the prior policyholders have no claim against such assets.

Many mutual companies issue nonassessable policies as provided under the various state laws, but in those instances where companies have not qualified to issue such policies, each policyholder is liable for an assessment equal to at least one annual premium in case of bankruptcy or impairment of minimum surplus requirements.

Reciprocal or Inter-insurance Exchanges:

A reciprocal exchange is composed of a group of persons, firms or corporations commonly termed "subscribers" who exchange contracts of insurance through the medium of an attorney-in-fact; each subscriber executes an agreement (usually called the subscriber's agreement), identical with that executed by every other subscriber, empowering the attorney-in-fact to assume on the subscriber's behalf an underwriting liability on policies covering the risks of the other subscribers. The subscriber assumes no liability as an underwriter on policies covering his own risk; his liability is several and not joint, and is limited by the terms of the subscriber's agreement. Customarily, the attorney-in-fact is compensated by payment of a percentage of premium income, out of which most operating expenses are paid; but a considerable number of exchanges pay their own operating expenses, and compensate the attorney-in-fact by a moderate percentage of premiums, or by some other method.

Methods of Producing Business

Companies acquire their business in different ways. The principal methods are as follows:

General agents:

General agents have an exclusive territory in which to produce business. They agree to promote the company interest, pay their own expenses, maintain a satisfactory agency force and secure subagents; they may do a good deal of the underwriting, and perform other services in connection with the issuance of policies and the adjustment of claims which neither local agents nor brokers are generally authorized or expected to do. General agents are compensated on the basis of a percentage of the premiums they produce. This percentage is higher than the percentage of the premium they pay to their local subagents whom they appoint or to the brokers from whom they secure business.

Local and regional agents:

Local and regional agents are authorized to write business, but are not usually given an exclusive territorial arrangement; they usually report either to company branch offices or directly to the home office and are generally compensated on the basis of a percentage of the premiums they produce, which is usually lower than the percentage allowed to a general agent.

Brokers:

Insurance brokers are "free lance agents" who solicit business and place it in different companies without a contractual relationship. They actually submit the business for acceptance or rejection directly to the company, through a general agency, local agents, or other brokers.

Direct writing:

Some companies, generally known as direct writing companies, sell their policies through either salaried or commissioned salesmen. Frequently this is done directly from the home office;

frequently it is conducted through sales branch offices. These employees only take the orders: underwriting and policywriting, etc., is done either in the branch offices or in the home office; salesmen generally do not have the power to bind the company on risks.

The distinction between an agent, a broker, and a salesman is based on their relationship to the insurance company. The agent, whether general or local, has the power to bind the company and is also an agent of the insured; he is an independent contractor in his relationship with the insurance company. Generally, the agent is considered to have a vested right in the renewal of policies he sells for the insurance company; the company cannot compel him to renew a policy if he prefers to place it with some other insurance company. The broker is an agent of the insured only. The salesman is an employee of the company and has no vested interest in the renewal of the policies for which he was initially responsible.

Methods of Adjusting Claims

The methods of investigation, adjustment and settlement of claims vary among companies. The more common methods are:
Adjustment bureaus:

An adjustment bureau is an organization established by a number of insurance companies who become members of the bureau and who refer to it for investigation and settlement some or all of their claims in some, or even all, territories. Subject to certain limitations, the adjustment bureau acts for each such company in the adjustment of and negotiations leading to the payment of claims, with the company retaining the final power of approval or disapproval. Expenses of the adjustment bureau are shared by all members on an equitable basis predicated in general upon the number and/or dollar volume of claims referred for adjustment.

Independent adjusters:

A great many companies refer their claims for investigation and adjustment to independent professional adjusting organizations who charge stipulated fees for their services.

Home and branch office adjusters:

> A great many companies, particularly casualty companies, adjust claims through their own salaried employees stationed either at the home or branch offices as may be found more convenient.

Most companies use at least two and frequently all three of the foregoing methods of adjusting claims. They may have a claim branch office established for closer supervision and better control of the cost of adjustments in territories in which they have a concentration of risks. In the territories in which their business does not warrant the establishment of a claim branch office, they may use independent adjusters or join an adjustment bureau.

Reinsurance

Insurance companies bring together a great many persons subject to insurable hazards and collect from them amounts which, it is expected, will be sufficient in the aggregate to pay all losses which will be sustained by the persons in the group during a given period of time. To accomplish this purpose the number of persons brought together must be large enough for the law of averages to operate; otherwise it will be impossible to make a reasonable estimate of the amount of losses which will be incurred by the group. Frequently, however, an insurance company may be offered, or may be compelled to accept, insurance of a class of which it does not have enough volume in the aggregate to permit the law of averages to operate. Ordinarily all, or some part of, a risk of this type is passed on to another company. It also frequently happens that a company may write a policy on a risk for an amount which is beyond its financial capacity to absorb. It will, therefore, pass a part of the risk to another insurance company retaining only as much as it can absorb. It may also be, particularly in the case of fire insurance, that a company has too great a concentration of policies in one locality and, therefore, will pass on some of the risks in this particular locality to another company so as to reduce its conflagration hazard. Spreading of risks in situations such as these is called reinsurance.

The mechanics of reinsurance depend upon the reinsurance contracts or treaties which specify the relationship between the reinsurer and the reinsured. The following are the principal types of reinsurance:

Pro rata reinsurance. Pro rata reinsurance is a sharing, on a predetermined basis, by the insurer and the reinsurer of premiums and losses on a risk, class of risks or particular portion of the insurer's business. In consideration of a predetermined portion of the insurer's premium or premiums, the reinsurer agrees to pay a similar portion of all losses and loss expenses incurred on the business so reinsured.

1. Facultative reinsurance—Each risk or portion thereof is reinsured individually and the reinsurer has the option to accept or reject each.

2. Treaty reinsurance—To avoid the time and expense of negotiating desired reinsurance on an individual or facultative basis, companies enter into contracts (called treaties) providing for the automatic reinsurance of any agreed portion of business written, thereby eliminating the necessity for submitting each risk to the reinsurer for his acceptance or rejection.

   (a) Quota share reinsurance—This is a reinsurance of a fixed percentage of each and every risk of the insurer of the type covered by the treaty. For example, under a 50 per cent quota share treaty the reinsurer will receive 50 per cent of the insurer's premiums less a ceding commission and will be obligated to pay 50 per cent of each loss and loss expense incurred by the insured. Quota share reinsurance is frequently used for new lines or by new companies; for example, a fire company just entering the casualty field may arrange for quota share reinsurance of only its casualty business.

   (b) Surplus reinsurance—This type reinsures on a pro rata basis only those risks on which the coverage exceeds a stated amount. Under a surplus treaty an insurer might reinsure what it considers to be surplus liability under each large dwelling policy which it writes. For example, the insurer might reinsure the amount of each dwelling policy over and above $25,000 so that on a dwelling policy for $40,000 the insurer would reinsure $15,000. He would therefore pay the reinsurer 15/40 or 37.5 per cent of the premium less the specified commission; in the event of loss under the policy the reinsurer would be liable for 15/40 or 37.5 per cent of the loss.

Excess reinsurance. Under this type of reinsurance, the insurer wishes to be protected against what it considers to be excess or shock losses. Since the insurer desires to limit its liability on any risk, class of risks or particular portion of its business to a stated amount, it contracts with a reinsurer to assume all loss in excess of this amount in consideration of an agreed premium. This type of reinsurance is generally used to supplement pro rata reinsurance and particularly on many casualty lines is used to supplant it. The costs of both the insurer and the reinsurer for processing excess reinsurance are much lower than for pro rata reinsurance.

1. Excess of loss reinsurance—This type of reinsurance provides that the insurer will retain for its own account all loss payments for each accident that do not exceed the stated amount or retention limit set in the agreement. The reinsurer reimburses the insured for the portion of any loss which is in excess of the insurer's retention. This type of reinsurance usually relates to each accident or occurrence, or series of accidents or occurrences arising out of one event.
2. Catastrophe covers—These are a special variation of excess of loss reinsurance, whereby the insurer protects himself from losses of more than a stated amount arising from any one loss or disaster of a catastrophic nature such as a hurricane or windstorm.
3. Stop loss reinsurance—Another type of excess reinsurance is the stop loss or excess of loss ratio reinsurance. This type of reinsurance provides that the insurer will suffer the losses

in their entirety until the total amount of loss is such that the loss ratio (losses divided by premiums) exceeds an agreed loss ratio; then the reinsurer will reimburse the insurer the sum that is necessary to bring the loss ratio down to the agreed percentage.

4. Spread loss reinsurance—Most commonly used in the fire insurance field it is designed to spread the insurer's losses over a period of years. The reinsurer agrees to indemnify the insurer for all losses over a stated amount as they occur. The premium for this reinsurance is customarily determined as a negotiated percentage of the sum of such losses over the most recent five-year period plus a charge by the reinsurer for this service. There is also both a minimum and a maximum premium for each year so that the insurer is protected to a certain extent against very large or shock losses.

Pooling

Pooling is the term frequently used to describe the practice of sharing all the business of a group of insurance companies affiliated or under common management among the members of the group. All premiums written by the associated companies are customarily ceded to or reinsured by one company; then, after provision for any required outside reinsurance, the premiums are in turn ceded back in agreed ratios. Losses, loss expenses, commissions, and other underwriting and operating expenses (excluding investment expenses) are similarly treated; each member of the group shares in the total business of the group and all will achieve similar underwriting results.

Underwriting Pools, Associations and Syndicates

There are in existence a large number of underwriting pools, associations and syndicates which were formed by several independent companies or groups of companies joining together in joint ventures to underwrite specialized types of insurance or to write in specialized areas through separate joint offices each with a distinctive name and a separate staff of employees. The associations issue individual or syndicate policies on behalf of the member companies who share in all such policies in accordance with an agreement, or the policies are issued directly by the member companies and then reinsured among the members in accordance with the agreement. The agreement stipulates the organization and manner of operation of the association and the pooling of premiums, losses and expenses. Such associations customarily handle all functions in connection with the specialized business that would otherwise have to be handled by specialized departments in each of the member companies. This usually results in a more economical handling of such business.

Chapter 2

REGULATION

The insurance industry is deemed to be a business vested with the public interest and is regulated by the various states. Statutes in all states provide for the organization and maintenance of an insurance department charged with the responsibility of supervising insurance companies and enforcing compliance with the law.

While statutes vary, they have as their principal objective the development and enforcement of measures designed to promote the following:

1. Solvency
2. Propriety of premium rates
3. Fair dealings with the policyholders
4. Uniform financial reporting

In the interests of solvency, the statutes restrict investment of a part of funds of insurance companies to certain types of securities, prescribe methods of valuation of securities and other assets, require maintenance of minimum reserves, capital, and surplus, and define those assets which are not permitted to be reported as "admitted assets" in annual statements filed with insurance departments. (See section on non-admitted assets.)

Since 1944 when the United States Supreme Court held that insurance was commerce and, therefore, was subject to the laws of the United States and not to the exclusive jurisdiction of the various states, all of the states have passed legislation requiring the insurance commissioners to approve most rates charged by insurance companies. This decision made pricing of insurance in concert a violation of the anti-trust statutes of the United States. However, since action in concert is necessary for the welfare of the insurance business and the public, Congress immediately passed the McCarran Act (Public Law 15) exempting the insurance business from the anti-trust laws of the United States so long as state legislation provides for supervision of insurance companies, including rate making. A company must file most rates with the insurance department of each state in which it is authorized to do business; no company may change its rates without formal or tacit approval of the state insurance department having jurisdiction.

The statutes also provide for certain standard provisions to be incorporated in policies and for the insurance department to review and approve the various forms of policies. Agents and salesmen must qualify for licenses granted by the insurance department before they may conduct business.

To promote uniform financial reporting, the statutes provide for the filing of annual or more frequent statements, in prescribed form, with the insurance departments and for the examination of insurance companies by the insurance departments at stated intervals. Annual statements are required to be filed on a calendar year basis.

In the majority of states, organization of insurance companies may not be undertaken without the authorization of the insurance department, and, in those states where such authorization is not required, approval of the insurance department is necessary for the completion of organization.

Insurance departments generally consist of an insurance director, commissioner or superintendent in charge with one or more deputies, and staffs of examiners, attorneys and clerical assistants. A commissioner usually is given a great many discretionary powers and can issue rules and regulations necessary to assure compliance with the statutes he is required to enforce.

National Association of Insurance Commissioners

The commissioners of the various states organized a National Association of Insurance Commissioners which meets twice a year and deliberates on the various subjects of interest to all insurance regulatory authorities. The Association has a number of standing committees that meet throughout the year to work out various plans and proposals for submission at the semi-annual meetings of the commissioners. Although the findings of the Association are not in themselves binding on any state, once a final conclusion has been reached as to the need for new rules or procedures or for changes in the old ones, its recommendations are generally accepted and adopted by the states by appropriate legislation or regulation.

The important activities of the Association include the field of financial reporting and examination. Special committees of the Association have developed and are maintaining a uniform annual statement and an examiner's manual, which is in the nature of an audit program.

To minimize duplication of examinations, the National Association of Insurance Commissioners designed so-called "convention examination" procedures. For this purpose, the country is divided into six zones with one state commissioner in each zone designated as chairman of the zone. Whenever a domiciliary state decides that an insurance company within its jurisdiction is subject to examination, it so advises the chairmen of all of the zones in whose territory the company transacts business. Each chairman then designates one of the states within his zone to represent the zone in the examination. The examining staff, therefore, consists of the domiciliary state examiner who takes charge of the examination and representatives of all or some of the zones in which the company transacts business. The report of this examination is filed with the chairman of each zone concerned and is known as a report on the "convention examination." The convention examination generally satisfies the statutory examination requirements of each state in which the company transacts business thereby eliminating the duplication which would occur if each conducted its own examinations of all companies coming within its jurisdiction.

Chapter 3

UNDERWRITING OPERATIONS — PREMIUMS

Daily Report ("Dailies")

One of the most important records in an insurance office is the daily report, sometimes called an "application," which is the company's copy of the policy that has been issued. It is the basis of practically all accounting and statistical information and should therefore include a complete record of all transactions affecting the policy.

The daily report is a duplicate copy of a portion of the policy written, containing all the information necessary for accounting and statistical purposes. The policies contain many printed conditions which are unnecessary in the daily report as they are standard and are familiar to the company's employees. Some companies use an abstract form for the recording of casualty transactions.

As the term "dailies" implies, copies of policies issued by agents are received in each day's mail at the company office. Copies of policies written in the offices of the company are, of course, immediately available for processing. If policy control is maintained, the dailies will be sent to departments maintaining such control so that the issuance of each policy may be noted on control records. Control records may consist of a list on a sheet or card of the policy numbers requisitioned from stock with sufficient space opposite each number to indicate by a date stamp, check mark or other symbol that the daily report has been received. An alternative method of handling policy control is to use a tabulated listing of policies written and recorded during the month (or a shorter period) as the basis for noting on the policy control record that the policy has been accounted for. In addition to being more efficient, this method proves that the policy has been issued and recorded.

Follow up of missing dailies, as indicated by missed policy numbers, is usually made periodically using form letters sent to the agents or branch offices listing the items that are missing and requesting, as to each item, the reason for the nonreceipt, or the dates of mailing if forwarded prior to receipt of the form letter.

A change in an existing policy is reported on a standard form referred to as an "endorsement" which is processed in much the same manner as the daily. The change may result in an additional premium, a return premium or no premium adjustment.

The "dailies" are distributed to underwriting departments where they are reviewed for acceptability of the risk and determination of the premium. If the business was produced by an agent or broker, the rate of commission (in code where data processing equipment is used) is entered opposite each item, unless commission rates are standardized so that the commission may be calculated on the total writings for the month. Many companies, in order to speed up the recording of business, preliminarily review the dailies, insert the commission rate, code and record them, and then perform the underwriting function.

In most states, a checking office or inspection bureau is maintained by the companies, either voluntarily or in accordance with state laws or regulations, to prevent rating violations on fire and extended coverage risks. Agents, if required, send their daily reports to the checking office and the latter, after inspection, forwards them to the company. Most inspection bureaus check only the rate on the daily so that before the daily reports start on their way through the accounting department, the computation of the total premium as entered by the agent will be checked or test-checked.

Reinsurance

Among the matters to be determined by the underwriting department are reinsurance arrangements. Underwriters usually note information relative to reinsurance on the daily reports or on special reinsurance forms attached to the "dailies." They note the amount of reinsurance to be effected with each of the facultative companies and under each treaty contract, and the date on which each of the reinsurance amounts is to be bound, which is ordinarily as of the date the policy was written.

Preparation of Records from Dailies

Dailies are usually sorted into batches in the underwriting departments. Each batch is coded and routed to the key punch division where cards or paper tapes are punched directly from the daily reports. In those companies where daily reports are abstracted, punching is done from the statistical copy of the abstract. The number of cards punched from the daily report depends on the system used and whether premium accounting is done on punched cards, magnetic tape, bookkeeping machine or other methods. Where all work is done on punched cards generally two sets of cards are prepared, accounting and statistical. When electronic data processing equipment is used, only the number of cards or the amount of paper tape necessary to record the required data is used. When bookkeeping machines or other methods for recording premiums receivable are used, daily reports or abstracts are routed to the bookkeeping machines for accounts receivable recording and then to the key punch division for punching of statistical cards. The monthly tabulations prepared from the statistical cards, classified by agents, or the totals accumulated by the EDP equipment, serve as a basis for entries recording the direct business written for the month, and establish controls for agents' balances.

Premium Balance Accounting

Some companies send monthly statements to their agents, while others supply their agents with "account current" forms which are prepared by the agents monthly. The forms generally provide a column for policy numbers and several columns for premiums so that all premiums subject to the same rate of commission may be segregated in the same column to facilitate the calculation of commissions. Provision is also made for recording return premiums, expenses or other items affecting computation of the agent's balance.

When "accounts current" are received from agents, a comparison is made of the listed transactions with those recorded on the company's records. This comparison usually discloses differences which require investigation by the company.

Most companies record on their books as premium income and uncollected premiums the totals accumulated from the dailies. There are many ways of handling differences between premiums as so recorded and as reported in the agent's account current. One method commonly in use (for companies on a punched-card basis) is to remove from the uncollected premium file cards representing items included in the agent's account current and to insert in their place one card for the net balance reported in the agent's account current and suspense cards, debit or credit, for (1) items included in the agent's account current but not yet recovered by the company and (2) differences between items included in the agent's account current and as recorded by the company. Variations of this method are used for premium balance accounting when mechanical or electronic equipment is used. Most companies utilize some method for establishing accounting control over these differences; many companies use a separate account entitled "agents' differences." However, some companies record premiums as reported in the agent's accounts current and carry differences in memorandum records.

Some companies carry their uncollected premium records on a gross basis while others carry these records on a net basis (net of commission).

There are at least two other basic methods in use by agents and brokers for premium balance accounting:

1. The company renders the agent or broker a monthly statement either on an individual item or on an account current basis.

2. The agent or broker pays the company for individual premiums as he collects from the insured.

There are also many companies that render a statement directly to the insured who, depending on circumstances, pays his premium directly to the company or to his agent or broker.

Insurance companies attempt to develop premium accounting systems so that any of the above methods may be used by agents, brokers or insureds in reporting and paying premiums.

The procedure followed for agents and brokers who do not report on the account current basis is, in general, similar to that outlined for account current agents, except that each premium transaction is treated as an individual item rather than treating the entire month's business of the agent as a unit for collection purposes. Accordingly the premium accounting department receives individual charges or credits for each policy, equal to the total monthly entry to the uncollected premium account. The individual records are usually received in the form of punched cards or abstract tickets. When premium balance accounting is performed by mechanical or electronic equipment each policy item may also be treated individually.

Reinsurance Accounting Records

In the case of facultative reinsurance, a monthly listing (or bordereau) detailing the particulars pertaining to each risk reinsured during the month is the usual method employed by the ceding company in reporting to the reinsurer. Treaty reinsurance is frequently handled in totals only, on a monthly or quarterly basis.

The accounting entries involving reinsurance ceded are relatively simple if one bears in mind that the ceding company is in the position of a purchaser of insurance coverage from the reinsurer: a charge is made to "Premiums on reinsurance ceded" offset by credits to "Commissions on reinsurance ceded" and "Ceded reinsurance balances payable." Conversely, since the reinsurer takes the position of the seller, he records the transaction by charging "Uncollected premiums" and "Commissions on reinsurance assumed" and crediting "Premiums on reinsurance assumed."

When pooling arrangements are in effect no reinsurance records are prepared until the direct writing records have been summarized and monthly or quarterly totals are complete. In other words, under a pooling arrangement, the only reinsurance entries required are prepared from totals of business written.

Audit or Reporting Premiums

The risk on many policies is not known at the time the policy is written; consequently, a deposit premium is charged at the inception of the policy. At intervals during the term of the policy or at the expiration of the policy the insured submits reports, or a company representative audits the insured's records, to enable the company to determine the premium for the period. The premium for workmen's compensation insurance, for example, is predicated upon the insured's payroll. The insured receives credit for the deposit premium when the final determination of the premium is made.

Installment Premiums

Many policies are written so that the premium is payable in installments. Annual premiums are frequently payable in three or more installments; premiums on longer term policies are frequently payable in annual installments. There is usually a small surcharge made for the privilege of paying on the installment basis. Some companies record the total premium on three- or five-year installment policies, together with related commissions, at the time the policies are issued. Others only record each annual installment as it becomes due.

Unearned Premiums

As soon as a policy is issued promising to indemnify for loss, the insurance company incurs a potential liability. The company may be called upon to pay the full amount of the policy, a portion of the policy, or nothing. It would be impossible to try to measure the liability under a single policy. However, since insurance is based on the law of averages, one may estimate from experience the loss on a large number of policies.

As state supervision of insurance developed, the insurance departments set about providing a legal basis for determining the potential liability under outstanding policies in order to establish an ample reserve for the protection of policyholders and provide a uniform method of calculation. It was recognized that, since the premium is expected to pay losses and expenses, and provide a margin of profit over the term of the policy, the portion measured by the unexpired term should be adequate to pay policy liabilities (principally losses and loss expenses) and return premiums during the unexpired term on a uniform basis for all companies. Therefore the unearned premium was adopted as the basis for computing the unknown liability on unexpired policies.

Statutory requirements, including methods of establishing the unearned premiums may be illustrated by the insurance law of one of the states, which reads in part as follows:

> Every insurer authorized to transact business in this state shall ... maintain reserves equal to the unearned portions of the gross premiums charged on unexpired or unterminated risks and policies . . . The liability for unearned premiums may be computed on the annual pro rata fraction basis applicable to the date of settlement as prescribed by the superintendent . . .
>
> In case the annual pro rata fractions do not produce an adequate reserve the superintendent may, in his discretion, require an insurer to calculate its unearned premium reserve upon the monthly pro rata fractional basis or if necessary, on each respective risk from the date of the issuance of the policy and in the case of premiums covering indefinite terms he may prescribe special regulations.

The annual pro rata basis assumes that business is written uniformly over the calendar year; consequently, it is assumed that all policies are issued at the middle of the year which is then the average date of issue. For example, on a three-year policy the unearned fraction at the end of the calendar year in which written would be 5/6, at the end of the next year 3/6, and at the end of the following year 1/6.

The annual pro rata basis produces reasonably accurate reserves only when a substantial portion of the business is distributed evenly over the year. If, because of seasonal or other circumstances, there is a preponderance of business in the first or last half of the year the reserve may be excessive or inadequate.

The monthly pro rata basis assumes that, on the average, the same amount of business is written each day of any month so that the mean will be the middle of the month. For example, one-year premiums written during the first three months of the year have at the end of the year the following unearned fractions: January—1/24, February—3/24, March—5/24.

Fire and casualty companies, with few exceptions, use the monthly pro rata fractional basis. Unearned premiums are calculated by applying the appropriate fractions or factors to the original premiums in force segregated by line of business, term and expiration. The premium for the full original term is used for this purpose since the fractions or factors are calculated on this basis. When a policy is cancelled it is necessary that the full original premium be deducted from the total premiums in force; otherwise premiums in force and unearned premiums would be overstated. During the life of a policy, changes are frequently made resulting in additional or return premiums. For example, a one-year policy expiring in June, 19xx may have the rate increased or decreased by a change in hazard after it has been in force for six months, in which case the insured might pay an additional premium or receive a return premium. Theoretically the full original premium for changes should be noted on the copy of the endorsement attached to the "daily" so that premiums in force for the one-year term expiring June, 19xx may be correspondingly increased or decreased; however, as a practical matter, many companies adjust the premiums in force by the amount of the actual additional premium or return premium, other than in the event of cancellation, on the assumption that the resulting errors in the premiums in force will largely offset.

If a company accepts reinsurance on a risk in mid-term, it must provide the same unearned premium reserve that would have been provided by the ceding company if reinsurance had not been effected. Therefore, because of the method of calculation of the unearned premium reserve, the original premium for the full term of the policy should be included in the premiums in force; otherwise the unearned premium reserve on the risk will be understated.

The basic data for calculation of unearned premiums (namely the term, expiration and original premium) is included in the basic punch card or other media used to record premium transactions. Periodically summaries are made by line of business, term, month and year of expiration if the company uses the monthly pro rata basis or by year of expiration if the company uses the annual pro rata basis. The total of these summaries is usually referred to as the contribution to the "in force" for the period. These summaries are combined with summaries of the premiums in force at the beginning of the period and, after expired business is excluded, result in premiums in force at the current date. Companies using electronic computers accumulate the necessary "in force" data on punched cards, magnetic tape or in the memory of the computer. The unearned premiums may then be calculated mechanically or electronically.

For purposes of the annual statement insurance companies are required to maintain their records so that they can determine separately at December 31:

1. Premiums in force on direct and reinsurance assumed business.
2. Premiums in force on reinsurance ceded business.

In order to save time in the calculation of the unearned premium reserve, most companies deduct reinsurance in force from gross premiums in force to arrive at net premiums in force.

Unearned Premiums on Unauthorized Reinsurance

Where reinsurers are not authorized to transact business in a particular state they are not subject to examination by that state; consequently, the state will not allow the insurer to reduce its liabilities because of reinsurance ceded to unauthorized reinsurers. Since unearned premiums in the annual statements are reduced for all reinsurance ceded, the insurer is obliged to establish a separate liability for unearned premiums on reinsurance in force with unauthorized reinsurers. The insurer is permitted to reduce this separate liability to the extent that he is holding funds of such reinsurers.

As unauthorized reinsurers vary from state to state, some companies calculate the separate liability with respect to their reinsurers unauthorized in any state in which the company transacts business and use this liability in the annual statement filed with every state in which it is licensed.

Outline of Auditing Procedures

The audit of premiums written, premiums in force and unearned premiums is interrelated with the audit of many other items in the financial statements of insurance companies. Inasmuch as the dailies are the basic records from which transactions are recorded, maximum efficiency may be obtained by co-ordinating the auditing procedures relative to premium income, commissions and expense allowances to agents and brokers, reinsurance assumed and ceded and related commissions, agents' balances or uncollected premiums, bills receivable taken for premiums, funds held by or deposited with ceding reinsurers, unearned premiums, certain casualty loss reserves and various expense liabilities.

An outline of a program relating to the audit of premium income and related accounts is presented in the following paragraphs:

Accounting for Policies Issued. A substantial number of companies do not maintain policy control; where policy control is maintained, a limited test should be made to determine that policies supplied to agents are promptly entered on the policy control records. A test should be made to determine that skipped policy numbers are investigated in accordance with the prescribed procedures of the company. A limited test might also be made to determine that policies shown by the policy control records to have been issued and received from agents have actually been so received.

Whether or not policy control records are maintained, a test should be made to determine that daily reports are recorded prior to filing. This can usually be accomplished by a test examination of daily reports in the files to determine that they bear entry stamps indicating that all premium transactions reflected thereon have been recorded.

Premium Income. The examination relative to premium income may be made by: (1) reviewing daily reports of selected agents and brokers for selected periods; (2) sampling transactions for the entire year under review; or (3) inspecting all recorded transactions for a selected period. All premium transactions reflected on the daily reports including reinsurance ceded transactions should be traced to the premium or transaction registers to determine that they have been properly recorded, particularly noting that term, month and year of expiration, and actual and original premiums have been properly entered. Such a test assures that the basis for premiums entering the premium in force and unearned premium records is proper. Where premium or transaction registers are not produced, because of the use of electronic equipment or for other reasons, the auditor should investigate the system of internal control in use and design his program accordingly.

For agents' accounts included in the test who render an account current to the company, the auditor should determine that daily reports used in the test have been properly reported by such agents as to both premiums and commissions thereon and that differences are under investigation on a timely basis. Accounts current utilized in these tests should be traced to proper entry in the agents' balance control and subsidiary records.

For all agents' and brokers' accounts selected in the test, regardless of whether they render an account current, determination should be made that commission rates shown by the daily reports are in accordance with contractual arrangements.

For agents and brokers who report on other than the account current basis or where premium balances are controlled gross, the auditor should examine a selected number of remittances to determine that differences, particularly commission differences and unsupported return premium deductions, are being investigated and resolved within a reasonable time.

Where reinsurance ceded is indicated by dailies, the computation of reinsurance premiums and commissions should be tested. In the event of return premiums or cancellation of the policy, the auditor should particularly note that the reinsurance return premium has been recorded.

The independent auditor should review the reinsurance contracts or treaties and test payments of commission on reinsurance assumed and ceded to determine that the commissions are in accordance with such contracts or treaties. Commissions on agency reinsurance assumed and ceded and on some other facultative reinsurance may usually be conveniently audited in conjunction with the audit of commissions on direct premiums. Commissions on reinsurance assumed or ceded, which is reported on monthly or quarterly accounts, may be readily audited by reference to such accounts and to the reinsurance treaties and, where more than one commission rate is involved, by reference to supporting details of premiums.

A review should be made of the procedures and controls in effect for the collection of earned premiums on auditor reporting form policies. Earned premiums receivable are frequently only controlled on a memorandum basis.

For three- and five-year installment premium dailies, the auditor should ascertain statistical department or other records are being properly maintained to insure entry of future installments.

Determination should be made that return premium transactions included in the test are properly supported by endorsements or cancellation evidence. A test-check of the calculation of return premiums is necessary; in the event of cancellation the original premium should be properly noted on the related daily report.

Records used in tests should form the basis for entry in the books of account; tests of footings, postings and calculations should be made where appropriate.

Many companies cut off premium registration somewhat earlier at year end than during interim periods. In addition, delays due to mail and checking of dailies by rating and inspection bureaus frequently result in a significant amount of December or prior months' business not being entered until the subsequent year.

However, there is frequently a substantial backlog of endorsement transactions (additionals, returns, cancellations and earned audit or reporting form premiums) due to inability to locate dailies, delay in making audits, delay in receipt of value reports from insureds, etc. There is also frequently a greater delay in the recording of reinsurance ceded transactions than there is in the recording of direct transactions (reinsurance ceded commissions are, of course, usually substantially in excess of commissions allowed to agents and brokers).

Since these factors tend to offset, the financial statements may not be materially affected; the company's practices as to these transactions at the year end should be ascertained and tests made to determine the effect on the financial statements.

Agents' Balances or Uncollected Premiums. Lists of agents' balances and uncollected premium account balances should be reconciled with the general ledger control account balance. Aging of the balances should be reviewed to ascertain that client's segregation as between "admitted" and "non-admitted" assets is in accordance with the requirements of the state insurance department.

Selected premium or agents' balances and balances resulting from reinsurance assumed should be confirmed. While it probably will be found practicable in most instances to confirm amounts receivable from agents by listing the open account current monthly balances, confirmation from brokers and others usually must be obtained on an individual policy basis. The propriety of the items for which confirmation was requested but not received should be tested by tracing details thereof to dailies and subsequent collection.

Entry of premium transactions in the premium register and in the agents' balance or uncollected premium records and the handling of differences should be tested in conjunction with premium income tests previously discussed.

Unearned Premiums. The company's unearned premium reserve will frequently be supported by listings of premiums in force and unearned by line of business and by term and expiration date. However, many companies using electronic data processing equipment do not make a list of in force and unearned in sufficient detail so that calculations can be checked. In this case arrangements should be made (preferably in advance) to secure detailed listings by terms and expiration for at least selected lines of business. Review the principles followed in the determination of premiums in force and test the calculations of the portion unearned. (The procedures for testing the recording of premiums for premium in force purposes were discussed in conjunction with the test of premium income.)

An analysis, with appropriate tests, of changes of premiums in force should be made for a selected period by lines of business as follows:

Premiums in force at the beginning of the period
Plus: Premiums written
Excess of original premiums over amounts received for additional premiums (endorsements) and reinsurance
Less: Excess of original return premiums over actual return premiums
Expired premiums
Premiums in force at the end of the period.

Relationships among these items should be scrutinized and compared with those of prior periods.

A listing of premiums expired during the period should be secured and tested to determine whether they are actually expired. Comparisons should be made separately of actual and original premiums as to both premiums and return premiums by line of business. Quantity and ratio comparisons should also be made of premiums in force, unearned premiums and premiums written by line of business for the current year and at least the prior year; unusual fluctuations noted in these comparisons should be investigated. Unusual reinsurance transactions or changes in trend from long- to short-term business may be the cause of some fluctuation.

Determination should be made that business from all sources (such as pools, associations, reinsurance assumed, etc.) has been included in premiums in force and unearned.

Unearned premiums should also include separate allowances for rate credits and retrospective return premiums based on experience as follows:

1. Return premiums due to retrospective ratings on compensation and liability policies. The premiums on such policies are determined after expiration based on the loss experience.
2. Audit return premiums on various casualty, fire or marine policies.
3. Return premiums due the insured under the policy for certain periods when the vessel is laid up.
4. Additional reserves on noncancellable accident and health policies.
5. Reserves for deferred maternity and other similar benefits.

A review should be made of the methods used in determining the allowance for retrospective return premiums and rate credits included in the unearned premium reserve. It should be determined that the methods used are appropriate and consistent with methods used in prior years; calculations and underlying data should be tested.

If the company only enters the current installment of premiums payable in annual installments, determination should be made that any necessary adjustment has been made in premiums in force and unearned; unearned premiums may be understated because, at times, the first installment on a policy may be somewhat higher than the other installments.

A listing of reinsurance in force by reinsurer should be reviewed; if there is any reinsurance in force with unauthorized reinsurers a liability should be established for the related unearned premiums. The liability is only to be established for the amount by which the unearned premiums on such unauthorized reinsurance exceed the funds of such reinsurers which are being held by the company. Funds held for the account of reinsurers, whether authorized or unauthorized, should be confirmed on a test basis.

Chapter 4

UNDERWRITING OPERATIONS — LOSSES AND LOSS ADJUSTMENT EXPENSES

Losses and related adjustment expenses incurred by an insurance company under its policies represent, in most lines of insurance, the largest single element of the cost of doing business. The fairness of the company's representation of its financial position and results of operations usually rests on the reasonableness of the estimates of unpaid losses more than on any other item. However, it is extremely difficult to estimate this element of cost accurately.

In most businesses cost information is available before sales are made. In the insurance business, however, the cost of the protection sold cannot be finally determined until after policies have expired and any losses adjusted. No peculiar or difficult accounting problem is encountered with losses that have been settled or with most property losses where reasonably definite information has been obtained; the determinations made in these cases usually result merely in minor corrections of estimates previously made. But the need to make provision, frequently far in advance of settlement for many casualty losses (i.e., liability, compensation, fidelity and surety losses) and for losses which have been incurred but have not been reported, presents a difficult problem, the resolution of which calls for the exercise of the greatest care and soundest judgment.

Since past experience is the principal basis used in the determination of the latter types of losses and related expenses, insurance companies pay great attention to the compilation of various loss data and to the development of related experience statistics. The importance of the completeness and quality of such material and the manner in which and the degree to which it is currently utilized in the company's loss accounting cannot be overemphasized.

Processing of Losses

The term "processing of losses," embraces all procedures and performances of the company incident to investigation, adjustment, payment or other disposition of losses and claims, and also includes related accounting and the development and maintenance of loss experience statistics.

Multiple line insurers usually have separate departments or sections to handle different types of losses and claims because of inherent basic differences. Property losses can usually be determined and settled in relatively short periods of time. However, many casualty claims present a wide area for disagreement and often require prolonged investigation and negotiation before agreement is reached as to the amount of damages.

In large companies there may be further specialization in the settlement of losses. Separate departments or sections may handle marine losses, workmen's compensation claims, claims under fidelity and surety bonds, and claims under miscellaneous lines of business.

Although detailed procedures vary, there is a common pattern of processing losses. Notices of loss or accident are received at the home or branch or divisional offices, either directly from the insureds or through agents or brokers. File numbers, which form a basis for all future references, are assigned to the cases reported. Cases may be registered in numerical sequence or other means of control may be provided. Dailies or applications are examined to determine that reported losses are actually covered by insurance policies in force at the time of the occurrence. If proper coverage exists, cases are assigned to adjusters for further field investigation, appraisal, negotiation and settlement, subject to appropriate supervision and approval by the company's loss department. The adjusters in the course of their investigations will determine, among other things, whether the claimed losses actually occurred, what they deem to be the proper amount of the losses, whether the losses may be excludable under the terms of the policies, and whether the company has any rights of salvage or subrogation.

Salvage is a recovery frequently made by the insurer after a loss has been paid and is treated by the company as a reduction of the amount of loss paid. Salvage recoveries are exercised by the insurer as a contract right which entitles it to any reimbursement arising from the disposal of property which has been damaged and for which the claim of the insured has been paid. Subrogation is the statutory or legal right of an insurance company to recover from a third party who may be wholly or partly responsible for the loss paid under the terms of the policy. Subrogation recoveries, similar to salvage, are applied in the accounts as reductions of losses paid.

As soon as practicable, estimates are made of the probable amounts payable on reported losses. Such estimates may be made on the basis of experience developed, by line of business, as to the average cost per case, or may be made on the basis of reported information with respect to individual cases. Revisions of these estimates are made, where appropriate, as changes in experience indicate or as investigations progress. Many insurance companies do not enter loss estimates in the general ledger but only maintain detailed memorandum records of them.

Various clerical operations are performed after notices of losses are received. Separate loss or claim files are prepared for the filing of all papers relating to each case. In addition, transcripts of loss containing abstracts of coverage and of loss notices, generally known as face sheets, as well as a considerable amount of coded information for later use in the development of statistics, are prepared in some multiple form. Copies of this form may be used for inclusion in the loss file for ready reference, as a branch office record, as an adjuster's assignment sheet, as a diary for home office follow up on the progress of settlement, as a claim card for the loss department's record of outstanding losses, as a notice to the tabulating department to prepare punched card or other records of case reserves and appropriate statistical distributions, as a notice to the underwriting department of current developments and to some extent as an experience record, as an index of insureds and claimants, and as a claim register.

As is readily apparent, the procedures described above are costly; consequently, there has been much effort to process smaller and "one shot" claims by less expensive methods. Usually this is accomplished by eliminating the preparation of an expensive set of claim records and the recording of an individual estimate on each small claim. There have been many methods developed to accomplish this including:

1. The combination and processing of a large number of small claims as one claim for statistical and accounting purposes.
2. The delay of all statistical and accounting processing until date of payment.
3. The use of average reserves on small claims.

Loss Accounting and Payment Procedures

Loss and loss expense payments may originate with a number of documents, including: signed proofs of loss, releases, medical bills, repair bills, or invoices for fees of independent adjusters, lawyers, etc. When these documents are received, they are reviewed and compared with the loss files; if in order payment is authorized. Authorized payments may be posted to the face sheets of the loss files and to the loss department's claim cards at this time. For reasons of economy some companies do not post loss payments either to the face sheets or claim cards but include evidence of such payments in the loss files.

Methods of payment vary among insurance companies. Approved documents may be forwarded to the cashier for draft or check preparation or the loss department may have authority to issue drafts. In many cases drafts may be issued by field offices, adjusters and sometimes agents. In such cases, copies of the drafts together with the supporting documents are forwarded to the loss department. After processing, the supporting documents are filed in the related loss files.

Accounting for losses paid by checks or for drafts handled on an issued basis commences at the time of issue. Some insurance companies record drafts issued in payment of losses only when the drafts are presented for payment by banks; accounting commences at that time. Drafts presented for payment should be compared with approved copies of the drafts.

Loss payments are classified by the use of source records (copies of checks or drafts, check requisitions, or other material). The records may be summarized manually but usually data processing equipment is used. In the latter case source material is forwarded to the data processing department, usually in controlled batches. Loss transactions are punched from the source material and totals of paid losses become the basis for posting to the general ledger.

Losses and claims must be classified by lines of business, as well as by state, location of risk and in some instances by date of loss and policy year in order to meet the reporting requirements of the annual statement.

Unpaid Losses and Loss Adjustment Expenses

The provision for unpaid losses and loss adjustment expenses includes estimates of losses in process of settlement, estimates of losses that have been incurred but which have not been reported, and estimates of loss adjustment expenses to be incurred in settling outstanding losses. To serve as a guide in the exercise of judgment with respect to current estimates, insurance companies, particularly in the case of casualty losses, rely heavily on past experience modified in the light of current conditions and trends. "Development" or "runoff" data is one of the most useful guides for this purpose. The preparation of such data involves a comparison by (1) policy and accident year, or (2) calendar year, of the estimates carried for reported and unreported losses outstanding at the end of a period with the subsequent "cost" of such losses to date, represented by actual payments plus the estimates for losses still unpaid. The development of experience data over a period of years provides an extremely useful pattern by which management may gauge the judgment of those charged with the responsibility of estimating loss reserves. Substantial differences disclosed by comparisons of estimated and actual costs of losses are usually investigated and may well indicate the need for adjustment of current estimates.

"Developments" are frequently prepared by line of insurance as shown on page 34.

Reported Losses. Estimates of reported losses in process of settlement are determined by inventory, i.e., by tabulation of loss estimates. Case reserves on larger losses are estimated on an individual basis by claim examiners from information supplied in loss notices and adjusters' or investigators' reports. The same procedure may be followed for small losses; however, the large volume of small losses causes many companies to arrive at these estimates by multiplying the number of outstanding cases by an average dollar amount per case determined on the basis of past experience.

Unreported Losses. Estimates of losses incurred but not reported are generally determined on a formula basis, i.e., the estimates are established on the basis of experience statistics of prior periods, modified, where indicated by current trend and other factors. One method used is to relate, by line of business, the emerging losses for a selected period or periods to the premiums in force at the beginning of such period or periods, and then to apply the factor thus derived to the premiums in force at the end of the current year. Another method is to relate the number and amount of claims reported after the close of a prior year or years to the total claims reported for those same years. The factor so developed is applied to the total claims reported for the year under review.

The formula basis of computing estimates is ordinarily used only for the normal run of losses. Exceptionally large losses, such as those to be paid in the event of a catastrophe, are excluded from the experience statistics and separate estimates are provided on the basis of available information and best judgment.

Loss Adjustment Expenses. Provisions must be made not only for reported and unreported losses, but also for the future costs of settling such losses. Loss adjustment expenses may be

Development at December 31, 1965 of Reported Losses at December 31, 1963 on a Calendar-Year Basis

Provision for Losses Reported Dec. 31, 1963 or Prior and Unpaid at Dec. 31, 1963	Loss Payments Jan. 1, 1964 - Dec. 31, 1965 Applicable to Losses Reported Dec. 31, 1963 or Prior	Losses Reported Through Dec. 31, 1963 Still Unpaid at Dec. 31, 1965	Developed Cost at Dec. 31, 1965 of Losses Reported Through Dec. 31, 1963 and Unpaid at Dec. 31, 1963	Indicated Savings or (Deficiency)
$2,000,000	$1,200,000	$700,000	$1,900,000	$100,000

Development at December 31, 1965 of Incurred But Not Reported (IBNR) Losses at December 31, 1963 on a Calendar-Year Basis

Provision for IBNR Losses at Dec. 31, 1963	Loss Payments Jan. 1, 1964 - Dec. 31, 1965 Applicable to Losses Incurred Dec. 31, 1963 or Prior and Reported Subsequent to Dec. 31, 1963	Losses Incurred Through Dec. 31, 1963 But Reported Subsequent to Dec. 31, 1963 and Unpaid at Dec. 31, 1965	Developed Cost at Dec. 31, 1965 of Losses Incurred But Not Reported at Dec. 31, 1963	Indicated Savings or (Deficiency)
$400,000	$280,000	$160,000	$440,000	($40,000)

classified as allocated or unallocated. Allocated expenses are usually considered to be those which can be directly identified with specific cases; unallocated expenses are usually considered to be those which cannot in any practical way be so identified (i.e., salaries, travel, rent, postage, stationery, etc.).

Provisions for loss adjustment expenses are usually estimated on a formula basis; however, some companies use case basis estimates. The formula factors may be developed by relating allocated paid loss expenses by line of business to paid losses, frequently for the most recent three- to five-year period; these factors, adjusted for trends, are applied by line of business to the unpaid losses at the time that financial statements are prepared. Because some portion of the expenses will have already been paid on many of the open cases, it is not unusual for companies to discount the ratio of expenses to paid losses on the basis of experience. Another and perhaps sounder method of estimating unpaid allocated loss expenses is to prepare a development schedule similar to that previously discussed for losses; the ratios developed from such schedules are applied to the current unpaid losses and adjusted for trends. Further refinements are often made. For example, experience data may be developed as to loss expense paid in the first year after the reserve date, the second year, the third year, etc.

Required provisions for unpaid unallocated loss adjustment expenses are generally estimated by relating paid loss expenses to paid losses for a prior period or periods and applying the developed ratios to unpaid losses at the statement date. Such ratios are usually applied in full to incurred but not reported loss provisions and, because a fairly substantial amount of such loss expenses has already been paid on reported losses, the ratios are usually reduced on the basis of judgment (very frequently by 50%) and then applied to unpaid reported losses.

Statutory Formula Reserves. Minimum reserves are required by statute in many states for bodily injury liability and workmen's compensation lines of business. They are computed by applying a stipulated percentage to the amount of earned premiums on policies written in each of the three most recent calendar years

(60% for bodily injury liability and 65% for workmen's compensation) and deducting from the result the loss and loss expenses actually paid on these policies. The minimum reserves so determined are compared with case basis loss and loss expense estimates ("case basis" as used in this sense includes reported and incurred but not reported cases and expenses applicable thereto); the larger amount for each of the three years is carried as the required reserve for the respective years. The case basis estimates for unpaid losses and loss expenses on policies which are more than three years old are added to these reserves, as well as any related voluntary additional reserves that a company may provide. Any excess of liability and compensation statutory and voluntary reserves over case basis and loss expense estimates is shown separately in the annual statement as a liability and any change in the excess between accounting periods is reflected in surplus.

Minimum reserves are also required in some states for losses incurred but unreported on fidelity and surety policies as at the statement date. These reserves are provided on the basis of prescribed percentages of the premiums in force for the respective lines of business.

Reinsurance Recoverable

The loss department, upon receiving a notice of loss, generally determines whether there is any right of recovery under a reinsurance agreement. In the case of pro rata reinsurance (other than quota share) this determination will be made by inspecting the daily report which shows appropriate reinsurance information. Recoveries under quota share reinsurance agreements are usually based on the appropriate total loss figures for the period. In the case of excess reinsurance the determination is made by the loss examiner based upon the terms of the applicable reinsurance contract. Recoveries under catastrophe reinsurance are usually determined on the basis of data compiled by the statistical department; each catastrophe is usually assigned a code number and a recovery is set up when the total incurred losses for any one catastrophe exceed the company retention.

When it has been determined that there will be reinsurance recoverable on a loss, the estimated amount recoverable is usually recorded on the claim file and on the data processing records either on a separate reinsurance recoverable loss reserve punched card or on magnetic tape, etc. Notices of losses are sent to reinsurers in accordance with terms of reinsurance contracts, in most cases, only for losses reinsured on a facultative basis and for the larger losses. The annual statement provides for reporting gross unpaid losses, related reinsurance recoverable and net unpaid losses. Listings prepared from the data processing records at statement dates provide the required data. The estimated amounts of unpaid losses recoverable from reinsurers are not recorded, except in very rare cases, on the general records. When losses and loss expenses are paid, however, most companies record the actual amount of reinsurance recoverable both in the general ledger and in subsidiary records which are frequently in the form of punched cards or magnetic tape. Some companies maintain a record of reinsurance recoverable on paid losses on a memorandum basis until collection is made.

Reinsurance recoverable balances must be segregated as between those recoverable from authorized companies and those recoverable from unauthorized companies. Insurance companies are required to provide a reserve for reinsurance recoverable from unauthorized companies to the extent that funds held or retained for account of unauthorized companies are exceeded.

Outline of Auditing Procedures

Generally, a review and tests of the loss procedures of an insurance company may be commenced at an interim date. The review should include an appraisal of the effectiveness of the loss department's supervision of loss settlements, reserving practices, and an evaluation of the soundness of the related internal procedures and controls in effect.

Paid Losses and Loss Adjustment Expenses. Detailed lists of paid losses, allocated loss adjustment expenses and reinsurance recoverable for a selected period or periods should be obtained and traced to the general ledger accounts. Loss or claim files should be examined for selected paid losses and allocated loss adjustment expenses. This examination should include inspection of dailies or applications to determine that the paid losses were covered by the insurance contract, were within the policy limits, and occurred within the policy period. Tests should also be made of account and other coding classifications. In addition, inspection should be made of proofs of loss, releases, loss expense invoices, correspondence from field adjusters and examiners' approvals. In the course of these tests the auditor should refer to related paid drafts or checks for propriety of amounts, and names of payees and endorsers.

Companies who use adjustment bureaus usually pay for adjustments of losses and claims on a monthly basis predicated upon the number of losses adjusted and a gradation of such losses by size; payments should be test-checked. It should be determined that the company, at least periodically, requests from the adjustment bureaus lists of paid losses on which it is being charged adjustment expenses and that the company at least tests such payments against its records.

In the course of examining loss or claim files to which reinsurance applies, losses and allocated loss adjustment expense recoverable should be traced to the reinsurance records. Rights to salvage or subrogation should be noted. A review should be made of the procedures and controls in effect for such items, and subsequent collections should be traced, on a test basis, through the accounting records.

Consideration may also be given to the desirability of confirming, on a test basis, payments to insureds or third parties and requesting confirmation from adjusters and attorneys of the status of a selected number of cases in which the records indicate salvage or subrogation collections are a possibility.

Reported Losses. Listings of losses reported but unpaid and reinsurance recoverable thereon as at the statement date, including estimates of unpaid loss adjustment expenses when estimated on a case basis, should be obtained and tested for arithmetical accuracy; totals should be traced to the financial statements. Open claim files should be examined on a test basis in support of the listed amounts. Final claim numbers included on the listings should be reviewed to determine the propriety of the cut off of reported losses. It should also be determined that previous estimates of recoverable amounts have been removed from loss estimates.

Where loss estimates are based on average costs a review should be made of the methods used in their determination, consideration being given to logic applied, trends over a period of years and whether volume is sufficient for results to be credible. Consideration should be given to the manner in which reinsurance recoverable is treated in the calculation of average costs, particularly where there is a substantial amount of reinsurance.

A comparison of loss statistics with those of the industry should be made. A review should also be made of the company's loss experience statistics for a period of years. Normally a development period of three to five years is needed to determine with reasonable accuracy the actual settlement costs of liability, workmen's compensation, fidelity and surety claims. The difficulty of accurately estimating the costs of settling outstanding claims is further complicated by long-range changes in the economy and the value of the dollar. In order to insure that the provision for outstanding claims will be adequate, it has generally been considered good practice to provide reserves that will exceed the actual expected developments by a nominal percentage. Any drastic change in the valuation of outstanding claims should serve as a warning that the estimating procedure should be investigated.

Unreported Losses. As explained previously, estimates for incurred but not reported losses are provided on the basis of past experience related to current exposure. Management frequently adds a safety margin to the estimates so developed.

Developed experience for incurred but not reported losses should be reviewed to determine the reasonableness of the company's estimates including tests of the propriety of percentages used and accuracy of computations.

Statutory Formula Reserves. The statutory requirements relating to the method of computing minimum reserves required by statute should be reviewed to determine that the company has complied with such requirements. Tests should be made of the details contained in the schedules supporting the amounts of such minimum reserves such as earned premiums, losses and loss expenses incurred, and premiums in force.

Unpaid Loss Adjustment Expenses. Where estimates for unpaid loss adjustment expenses have been established on a case basis, the auditing steps to be followed have been previously outlined under the caption "Reported Losses." Where such estimates have been established on a formula basis, the developed experience should be reviewed and tested to the underlying records, and the calculation and application of percentages should be checked. Comparison should also be made with experience statistics for prior years to determine whether the current developments appear to be reasonable and whether the methods used have been consistently applied.

Reinsurance Recoverable on Paid Losses. At year end a summarization of balances by reinsurer should be compared with the general ledger control account and the subsidiary records and test confirmation obtained.

Unauthorized Reinsurance Recoverable. The auditor should ascertain that appropriate recognition has been given to the requirement that reserves must be established for losses recoverable from reinsurance companies not authorized to do business in the various states to the extent that such losses exceed funds held or retained for the account of such companies. A list of all authorized companies is furnished in instructions issued by the insurance departments of some states. Funds held by or retained for account of unauthorized reinsurers should be confirmed.

Chapter 5

INVESTMENT OPERATIONS

Insurance statutes generally regulate the investments of insurance companies either by stating specifically which types of assets shall be included among "admitted assets" or by giving the supervisory authorities the power to pass upon the admissibility of assets, or both. Some state laws prescribe the types of bonds, stocks, and mortgages which may be acquired by the companies as well as the limitations on amounts of individual investments and aggregate classes of investments.

Investments of fire and casualty companies consist primarily of bonds and stocks. Some companies may also own mortgage loans. Real estate investments are generally restricted to office buildings and other facilities for company use.

Common practice in the industry is to reflect bonds at original cost reduced by amortization of premiums or increased by accretion for discounts. If the bond is in default, however, as to principal or interest, values published by the National Association of Insurance Commissioners must be used. Amortization is usually calculated by the scientific or straight line method; many states require the use of the scientific method (yield method). In the case of bonds purchased at a premium and which are subject to call before maturity, the premium should be amortized to maturity or an earlier call date, whichever results in the lesser amortized cost at the statement date.

Companies which record amortization on their records reflect amortization of the premiums and accrual of the discounts as an adjustment of interest income of the period. Some companies do not record amortization on their records; amortization accordingly is reflected in unrealized appreciation or depreciation in their annual statements; upon sale or maturity of the bond the realized gain or loss is determined in relation to original cost.

Most stocks are reflected in the annual statement at values published by the National Association of Insurance Commissioners. These are based generally on market quotations but include dividends declared on stocks payable after December 31 which are quoted ex-dividend on that date. Stocks of subsidiaries are valued at the pro rata portion of their capital stock and surplus at the statement date. In determining surplus of noninsurance subsidiaries, assets and liabilities must be stated on the basis prescribed for insurance companies.

The admitted asset value for mortgage loans is generally equivalent to face amount, but for each loan it is generally limited to the greater of a prescribed amount or a fixed percentage of total admitted assets. Mortgage loans are only considered admitted assets if they are first liens on property.

The gain or loss resulting from the change during the year in the difference between book value and admitted asset value is reflected in the surplus account as unrealized capital gain or loss. Thus such gain or loss includes changes in the non-admitted portion of investments (the excess of book value over admitted asset value). Net realized capital gain or loss is shown in the investment section of the income statement.

Investment income from real estate may include rent on space occupied by a company in its own building. A contra charge is reflected in expense.

Interest, dividends and real estate income due and accrued reflected as an admitted asset includes dividends, if any, payable on or before the balance sheet date but which were not received; dividends payable in the subsequent period are not included in the accrual but, as stated above, are recognized in valuing stocks.

The excess of admitted asset value of investments over book value and interest, dividends and real estate income due and accrued are termed "non-ledger assets" since they are usually not recorded on the general ledger.

Outline of Auditing Procedures

The principal objectives in the audit of investments involve the establishment of ownership, the legality of the investment, the basis of valuation and the accounting for income and gains and losses. Schedules A, B and D of the annual statement provide a detailed listing of real estate, mortgages, and bonds and stocks, respectively, at the end of the year as well as details concerning acquisitions and disposals during the year and income earned on individual investments.

The legality of investment holdings should be checked by reference to applicable state laws.

Securities owned (and also securities held as collateral or as salvage) should be inspected or confirmed with custodians or other holders as of the audit date. Mortgage loans should be confirmed and documents tested.

Tests should be made of the amortization computations used in determining the valuation basis for bonds and consideration should be given to the need for a valuation allowance. The valuations for stocks may be compared with quotations listed in financial publications (allowing for the elimination of fractions and the inclusion of dividends on stocks quoted "ex-dividend"). The method of determining valuations for stocks of other insurance companies and for subsidiaries should be reviewed. The audit of investments in real estate involves the application of the usual steps associated with fixed assets.

Security transactions and interest and dividend income should be appropriately tested. Significant outside income from real estate investments should be tested by reference to source data and the reasonableness of rents for company occupied premises should be reviewed.

Chapter 6

SUNDRY UNDERWRITING AND INVESTMENT EXPENSES

Sundry underwriting and investment expenses, except for commissions based on premiums, are generally recorded on the cash basis of accounting and converted to the accrual basis at the end of the year.

Uniform Accounting Instructions for Expense Reporting

The handling of expenses for an insurance company becomes largely a matter of cost accounting. Each expense is required to be allocated by classification, administrative function, and line of business. This requirement is found in the uniform accounting instructions (called Regulation 30 in New York) which have been in effect for all states since January 1, 1950. The purpose of the uniform accounting instructions is to provide a consistent means of comparison between companies and years and to furnish a basis for rate study by state authorities. Its objective is to establish uniformity in the allocation of expenses by these principal groupings:

1. Basic operating expense classifications
2. Companies, if more than one insurance company is operated jointly
3. Functional expense groups
4. Lines of business

The principal bases for expense allocations are as follows:

1. All expenses which are incurred for a specific company, or for a specific function or line are allocated directly.

2. Expenses not directly allocable but related to certain direct expenses are allocated in the same proportion as the direct expenses to which they relate.
3. Expenses which are not related to any direct expense may be allocated on the basis of time studies or any other satisfactory method.
4. Expenses which are not subject to allocation based on time or special studies are to be allocated on the basis of premium volume or other reasonable basis.

Companies are required to maintain adequate records which substantiate the various allocations made.

After distribution to operating expense classifications, expenses are allocated to the following functional groups:

1. Investment expenses
2. Loss adjustment expenses
3. Acquisition, field supervision, and collection expenses
4. Taxes
5. General expenses

Commissions to Agents and Brokers

The commissions (other than contingent commissions) which companies agree to pay agents or brokers are based on a percentage of premiums. Commissions are an acquisition cost and are recorded as an expense at the time the related premiums are recorded, even though the premiums may apply to policies running longer than one year or expiring after the year end. The liability for unpaid commissions is netted against the asset "Agents Balances or Uncollected Premiums."

Contingent commissions result from agreements with agents and brokers whereby they are allowed additional commissions contingent upon favorable loss experience of the business they place with the company. There are many theories concerning the establishment of the provision for unpaid contingent commissions. One of the greatest difficulties arises because many contingent commissions are payable on a fiscal year basis rather than a calendar year basis. Some of the methods used in establishing this provision are:

1. Estimating amounts due on all contingent years closed during the current or prior years but not yet paid and making no provision for any contingent commissions that might be due on contingent years not yet closed.
2. The amounts developed under the first method plus the estimated amounts due at December 31 on contingent years not yet closed. This method appears to be more realistic than the first method as it results in a better matching of expenses and income and is certainly more conservative. However, for any company where a large number of agents receive contingent commissions on a fiscal year basis, it is not practical to actually compute all contingents and therefore they are estimated.
3. Many companies attempt to estimate this liability on an over-all basis based on past experience.

The independent auditor is, of course, concerned with the consistency of the basis for determining the reserve between years.

Commissions on Reinsurance

All reinsurance is contractual. Treaties set forth the commissions to be allowed to the ceding company, generally applicable only with respect to pro rata reinsurance. The commission is usually sufficient to reimburse the ceding company for its acquisition expenses, premium taxes and board, bureau and association expenses on the business reinsured. So that the ceding company may participate in the profits on reinsurance, the treaties frequently provide for commissions at a fixed rate plus a contingent commission or for commissions on a sliding scale. The commission rate under sliding scale commission arrangements is generally predicated on the loss and the loss expense ratio subject to a designated minimum rate; however, there is usually a provision for the carry forward of any loss suffered by the reinsurer due to the application of such minimum rate.

On excess reinsurance, the premium is usually a percentage of the ceding company's net premiums for the class or classes of business reinsured and is generally not subject to commission.

Taxes (Other than Federal Income Taxes)

The principal tax in this category is called premium tax because it is based on premiums written within the borders of a taxing authority. The rate of this tax varies among states, usually ranging from 1½% to 4%. In some cases counties and municipalities also levy taxes based on premiums.

Federal Income Taxes

Fire and casualty insurance companies are divided into two categories for Federal income tax purposes, namely stock and mutual, to which special provisions apply. All provisions of the tax law not inconsistent with the special provisions are applicable to the taxation of such insurance companies. Accordingly, fire and casualty insurance companies provide accruals in the usual manner.

Other Expenses

Other unpaid expenses at the close of the year are accumulated by an inventory of bills on hand and unpaid, expenses incurred but unpaid, expenses accrued by reason of the running of time or by the application of contract or treaty.

Outline of Auditing Procedures

Commissions. As previously mentioned the checking of agents' and brokers' regular commissions should be undertaken in connection with the review of dailies.

Contingent commissions paid during the period should be tested. Agents' contracts should be reviewed to determine whether contingent commissions were calculated in conformity with contracts; calculations should be tested. Supporting data as to premiums and losses should be tested.

The auditor should also determine with respect to reinsurance assumed and ceded that sliding scale commissions have been adjusted and contingent commissions have been calculated in accordance with the terms of the various treaties.

Taxes and Other Expenses. Tax returns should be examined on a test basis in support of payments and adequacy of accruals for the various state taxes and sufficient tests made to determine that the taxes have been properly calculated and the allocable credits taken. Federal income tax accruals should also be reviewed.

A representative group of invoices or vouchers should be selected for examination. The number of invoices and method of selection must be determined by the exercise of professional judgment in each particular case. However, it is important that all significant types of expenses be included.

The auditor should examine the company's records to determine that expense allocations are being made on a consistent basis and in keeping with the purpose of the uniform instructions issued by the regulatory bodies.

Tests should be made to determine that all liabilities are properly included at the close of the year on the annual statement. The auditor should test the calculations of those accruals that lend themselves to such treatment; other accruals should be reviewed as to reasonableness and the consistency of their development.

He should also determine that proper provision has been made for additional premiums on reinsurance ceded contracts on which deposit premiums were originally paid but which are subject to periodic adjustment. Reinsurance ceded on an excess of loss basis and catastrophe covers are usually subject to such adjustments.

Chapter 7

CAPITAL AND SURPLUS

The recognized concept as to the significance of capital and surplus in the insurance industry is best indicated by the caption used in the annual statements to describe total capitalization. This caption, "Surplus as regards policyholders," places the emphasis on solvency insofar as the policyholders are concerned and tends to subordinate the investors' viewpoint.

In the case of stock companies, the amount of capital stock required to be issued and maintained is governed by the respective state insurance laws. The law usually prescribes the minimum value of the shares that may be issued. In addition to the minimum capital stock requirements, there is a provision for the payment of an additional amount in the form of surplus equivalent to a prescribed per cent of the minimum capital stock.

In lieu of capital stock, mutual companies are organized with prescribed minimum surplus requirements which vary among states. Such surplus requirements may take the form of guaranty funds, guaranty capital, or other permanently designated funds subject to the payment of interest and subject to repayment under conditions prescribed by the respective state laws.

Typical surplus transactions, in addition to the gain or loss from operations, include several items peculiar to the insurance industry. These items consist of the following:

Net unrealized capital gains or losses

Unrealized capital gains or losses originate as a result of the prescribed method of valuation of investments. The change in the difference between book value and prescribed value occurring between reporting dates is charged or credited to surplus as unrealized capital gains or losses.

Changes in non-admitted assets

Certain assets are excluded from the balance sheet when reporting to the regulatory authorities.

Change in excess of statutory and voluntary loss reserves over case basis and loss expense reserves

It should be noted that adjustments to the case basis loss and loss adjustment expense estimates are accounted for in the statement of income.

Change in liability for unauthorized reinsurance

The various states require that a liability be carried for reinsurance recoverable from unauthorized reinsurers on account of unearned premiums or paid or unpaid losses to the extent that such reinsurance recoverable exceeds funds held or retained for account of such unauthorized companies. The increases or decreases during the period in the liability for unauthorized reinsurance are charged or credited to the surplus account.

Change in foreign exchange adjustment

Changes for the year in assets and liabilities due to foreign exchange rates.

Dividends to stockholders

Some state laws permit dividends to be paid out of surplus regardless of the source, so long as the minimum statutory surplus amount is maintained.

Outline of Auditing Procedures

Except for the need to check the statutory minimum capital and surplus requirements applicable to the lines of business written by the company, the audit of capital and surplus is similar in all respects to that of other industries.

In view of the tendency to accumulate all types of surplus in one account, it is frequently necessary to analyze the account as to sources of surplus. The applicable state laws should be reviewed to ascertain compliance with restrictions on surplus.

The validity and propriety of miscellaneous surplus items should be ascertained.

Chapter 8

NON-ADMITTED ASSETS

Non-admitted assets include all assets other than those permitted to be reported as admitted assets in the annual statement. The principal non-admitted assets are:

1. Excess of book value over investment value of bonds
2. Excess of book value over market value of stocks
3. Agents' balances or uncollected premiums over three months due
4. Equipment, furniture and supplies
5. Automobiles

Even though equipment, furniture, supplies and automobiles are classified as non-admitted assets, electronic equipment is, under certain circumstances, allowed as an admitted asset. Some companies charge equipment, furniture, supplies and automobiles to expense in the period of acquisition rather than treating them as non-admitted assets.

There are many other non-admitted assets which are usually not important as to total dollar amount. Those most frequently encountered are:

1. Bills receivable, past due, taken for premiums
2. Excess of bills receivable, not past due, taken for risks over the unearned premiums thereon.
3. Bills receivable, not taken for premiums

4. Loans on personal security, endorsed or not
5. Debit balances due from employees or fieldmen and other unsecured receivables
6. Company's stock owned
7. Loans on company's stock
8. Deposits in suspended banks, less estimated amount recoverable
9. Mortgage loans other than first liens and the excess of loan balances over appraised values of mortgaged premises
10. Funds held by or deposited with ceding reinsurers who are insolvent or in some states the excess of such funds over the liabilities to such ceding reinsurers
11. Leasehold improvements
12. That portion of equities in underwriting syndicates or associations representing non-admitted assets of such syndicates or associations

Most of the preceding non-admitted assets are self-explanatory. In general, receivables, except those acquired in the direct course of the business such as premium balances, premium notes or reinsurance recoverable on loss payments, are automatically classified as non-admitted assets unless they are collateralized.

Bills or notes receivable are utilized as a method of financing premiums, generally in those states or territories where installment premiums are not permitted or are not customary. There is a similarity to installment premiums in that the total of unpaid installments or the unpaid note balance is usually less than the unearned premiums which would be due the insured in the event of cancellation of the policy. Bills or notes receivable taken from insureds for premiums, if past due, are classified as non-admitted. The excess of the balance due on bills or notes not past due over the unearned premiums on the underlying policy or policies is also a non-admitted asset. All bills or notes receivable, except those taken from insureds for premiums or those fully secured by collateral, are also classified as non-admitted assets.

In many states insurance companies are not permitted to own their own stock. Loans on company stock, which generally arise from sale of stock to employees, are also classified as non-admitted assets.

Funds held by or deposited with ceding reinsurers are usually permitted to be reported as admitted assets. However, when the funds held are in excess of the liabilities of the reinsurer to the ceding company, such excess is classified as non-admitted. Funds held by or deposited with an insolvent company are also non-admitted.

Outline of Auditing Procedures

The auditing procedures applicable to many of the non-admitted assets were discussed previously.

Assets such as equipment, furniture, automobiles, leasehold improvements, bills or notes receivable not taken for premiums, loans on personal security, balances due from employees and fieldmen and other unsecured receivables, company's stock owned and loans on company's stock are frequently encountered by the auditor; consequently, the applicable auditing procedures will not be discussed here.

Bills or notes receivable taken from insureds for premiums should be test confirmed, selected notes should be examined and the detailed trial balance of notes should be test-checked and the total thereof agreed with the control account. A review should be made to determine that notes past due and the excess of note balances over unearned premiums on the underlying policies have been properly classified as non-admitted assets.

A review should be made to determine that funds held by insolvent ceding companies and funds held in excess of liabilities of the reinsurer to the ceding company have been properly classified as non-admitted assets.

Chapter 9

THE AUDITORS' REPORT

Insurance companies are required to report at least annually to the state agencies regulating the insurance business. Since the primary purpose of regulatory laws enacted by the various states has been the protection of policyholders, all of the statutes have as one of their principal underlying objectives the development and enforcement of measures concerned with the solvency of the individual company. Administration of these statutes has been vested in state insurance departments which prescribe the content and form of financial statements, known as the "annual statement," which have to be filed with these departments.

To comply with the reporting requirements of the regulatory authorities the companies must follow prescribed accounting practices which differ in some respects from generally accepted accounting principles followed by other business enterprises in determining financial position and results of operations.

Statements on Auditing Procedure No. 33 states that the basic postulates and broad principles of accounting comprehended in the term "generally accepted accounting principles" which pertain to business enterprises in general apply also to regulated companies, including insurance companies. This raises practical problems in audit reporting because the significance of the differences which may exist between these two bases has not in many cases been fully evaluated.

Representatives of the Institute have discussed the variances between prescribed insurance accounting practices and generally accepted accounting principles at great length with certain members of the insurance industry. The prescribed accounting practices considered to involve variances from generally accepted accounting principles are discussed in the following paragraphs, with the views of certain industry members in italics following each section.

Matching of Income and Expenses

One of the financial reporting practices which insurance companies must follow is that no recognition may be given to prepaid expenses or deferred charges. All costs, such as commissions, premium taxes and other items, in connection with writing insurance and obtaining premiums must be charged against income as they are incurred. Premiums, however, must be taken into earnings over the periods covered by the policies.

Accordingly, in a period of increasing premium volume, the results of statutory underwriting operations of a company are depressed to the extent of the expenses applicable to the increase in unearned premiums which will be reflected in income of later years. Conversely, in a period of declining premium volume statutory underwriting results are benefited by premiums taken into income whose related costs were charged against income in prior periods.

In most cases such costs allocable to unearned premiums are material in relation to total capital, and, in many companies, the change in such costs from one year to the next is material in relation to the statutory underwriting income.

Although it has long been customary in the insurance industry to estimate the resulting equity in unearned premiums (prepaid acquisition expenses applicable to unearned premiums) at 40 per cent for fire lines and 35 per cent for casualty lines, the amount in each individual company depends on several factors which must be investigated before a computation can be made. The tentative estimation of this equity should be based on that percentage, determined on significant lines or groups of lines of business, of the unearned premiums which the appropriate acquisition and related costs incurred during a representative historical period bear to the premiums written during that period. The percentage applied to unearned premiums in the tentative estimation should generally not exceed the percentage derived by deducting from 100 per cent the sum of (i) the anticipated loss ratio, (ii) the anticipated loss expense ratio, and (iii) the anticipated ratio of expenses subsequent to acquisition. Determining anticipated loss, loss expense and general expense ratios usually requires an analysis of historical data for the company plus knowledge of other factors such as giving greater weight to the more recent loss experience and taking into account recent rate changes which would be reflected in the unearned premiums in the balance sheet. It would also be necessary to recognize the results of the related Federal income tax effect.

Certain members of the insurance industry do not concede that the existence of what the industry regards as conservatism in unearned premium reserves is necessarily ipso facto in conflict with generally accepted accounting principles appropriately applied to insurance business, nor is it conceded that an "asset" in the nature of prepaid expenses actually exists. They contend that the margin of conservatism in the unearned premium reserve liability is analogous to the margins of conservatism in the evaluation for other types of enterprises of a number of kinds of assets and liabilities. In any disclosure of the existence of this variation, it should be made clear that it arises from accounting methods which are prescribed by law.

Valuation of Investments

Stocks are, in general, carried at market or appraised values, which is an acceptable practice. However, no provision for income taxes is made with respect to unrealized appreciation on such investments.

Certain members of the industry are of the opinion that the absence of recognition in the financial statements of a potential tax with respect to unrealized appreciation is appropriate if, as in the case of most insurance companies, there is no realistic expectation of material amounts of tax becoming payable.

Capital Gains and Losses

The annual statement provides that realized gains or losses should be included in the determination of statutory net income.

In some instances, the gain on sales of investments far exceeds the other operating results and its inclusion in statutory net income has the effect of turning a substantial loss for the year into a profit. Furthermore, unrealized gains or losses resulting from periodic changes in the relationship of investment cost to market or other values (i.e., changes in unrealized appreciation or depreciation) are required to be recognized and treated as direct credits or charges, respectively, to surplus.

Certain members of the industry believe there is no single approach to the treatment of realized and unrealized capital gains which will simultaneously satisfy all of the requirements of informative reporting for insurance company operations. This being the case, adequate disclosure in financial reporting should be sufficient.

Non-admitted Assets

Non-admitted assets are required to be excluded from the annual statement without regard to their realizable or useful value. Furthermore, some companies charge equipment, furniture and automobiles to expense when purchased rather than treating them as non-admitted assets and charging depreciation to expense.

Certain members of the industry consider the accounting treatment accorded non-admitted assets to be a conservative approach and one that usually has no material effect on the financial statements.

Statutory Reserves

Insurance companies are required to maintain loss and loss expense reserves for certain types of risks at the higher of an amount determined by the use of a statutory formula or an amount determined by the company based on adjusters' estimates case by case plus company-determined formulas for certain classes of outstanding losses. Since the company's estimates are determined in the light of particulars of individual cases, and its experience with similar claims and current trends, they generally represent a more realistic measure of the losses which will have to be met than do reserves determined by statutory formula.

When a company deducts from its unearned premium reserve liability the unearned premium on reinsurance ceded by it, the state regulatory authorities may not recognize the propriety of such deduction unless the assuming company is authorized to do business in that state and hence is subject to its jurisdiction and regulation, or unless the deduction is backed by funds of the assuming company retained by the ceding company. The disallowance of such a deduction is reported in the statement of the ceding company by establishing a liability "unearned premiums on reinsurance in unauthorized companies . . . Less funds held or retained by company for account of such unauthorized companies . . ." Similar treatment is accorded to deductions from loss and loss expense reserves for reinsurance recoverable from "unauthorized" companies.

Certain members of the industry consider that the accounting treatment accorded the statutory reserves is conservative but not in conflict with generally accepted accounting principles.

Form of Opinion

The insurance laws of some states contain certain prohibitions against the publication by insurance companies of financial statements based on accounting practices differing from those used in preparation of the annual statement. However, such laws generally permit the inclusion in published reports of supplemental data to the annual statement.

As previously stated, Statements on Auditing Procedure No. 33 on page 70, in paragraph 38, states that "The basic postulates and broad principles of accounting comprehended in the term 'generally accepted accounting principles' which pertain to business enterprises in general apply also to companies whose accounting practices are prescribed by governmental regulatory authorities or commissions. (Such companies include . . . insurance companies . . . and the like.)" This conclusion raises practical problems in reporting on examinations of insurance companies because the significance of the differences which exist between prescribed insurance accounting practices and generally accepted accounting principles in many cases have not been fully evaluated or resolved. To meet the requirements of Statement No. 33, it is generally necessary to provide supplemental data indicating the effect of the applicable variances between prescribed accounting practices and generally accepted accounting principles, as discussed in the preceding sections of this chapter, either in the form of notes to the financial statements or in appropriate supplemental schedules.

The need to supplement the statutory financial statements has long been deemed necessary by the independent public accountant in connection with registration of insurance companies' securities under the Securities Act. In connection with an SEC filing, the primary statements of assets and liabilities and income and surplus which are included are prepared in accordance with statutory requirements. In addition, supplemental information is given which reconciles capital stock equity and the income statement as presented with those as determined in accordance with generally accepted accounting principles. This practice, developed by the accountants, was formally adopted by the Securities and Exchange Commission in Accounting Series Release No. 89 announcing the adoption of the revised Article 7. The requirement as set forth in Regulation S-X is as follows:

> State in tabular form in a note or otherwise, together with appropriate explanation, a reconciliation of material differences between (a) capital share equity as reported on the balance sheet and capital share equity as determined in accordance with generally accepted accounting principles and practices, and (b) net income or loss as reported on the profit and loss or income statement and net income or loss as determined in accordance with generally accepted accounting principles and practices.

An independent auditor's opinion and the forms in which the required reconciling supplemental data may be presented as supplemental schedules are illustrated below. The suggested language and forms should, of course, be adapted to the particular circumstances.

> We have examined the Statement of Admitted Assets, Liabilities and Surplus of X Company at December 31, 19__, and the related Statements of Income and Changes in Surplus for the year then ended, together with the related supplemental State-

Statement of Adjusted Net Income

Net income (loss) as shown in the accompanying Statement of Income		$......
Adjustments [these will be added or deducted as appropriate]:		
Net realized gains or losses on investments [to segregate them from net income if so included]	$......	
Income taxes applicable to net realized gains or losses [to segregate from net income]	......	
Increase or decrease in acquisition costs applicable to unearned premiums [difference between amounts at beginning and end of the period]	......	
Difference between depreciation and cost of furniture, equipment, automobiles and leasehold improvements [if purchases are charged to expense]	......	
Future income taxes or reductions applicable to increase or decrease in acquisition costs [taking into account, with explanation, losses and loss carryovers on income tax basis]	......	......
Net income, as adjusted [excluding investment gains and losses]		$......
*Investment gains and losses**		
Net realized gain or loss	$......	
Less income taxes	......	$......
Increase or decrease in net unrealized gain or loss	......	
Less allowance for future income taxes	......	......
Net investment gain or loss		$......

*If amortization of bond premiums and discounts is not treated as an adjustment of interest income, the realized and unrealized gains and losses would require adjustment.

Policyholders' surplus as shown in the accompanying Statement of Admitted Assets, Liabilities and Surplus		$......
Adjustments [these will be added or deducted as appropriate]:		
Acquisition costs applicable to unearned premiums [at end of the period]	$......	
Unearned premiums and losses recoverable on reinsurance in unauthorized companies [total as shown among liabilities, if satisfied as to solvency of the unauthorized reinsurers]	......	
Excess of statutory and voluntary loss and loss expense reserves over case basis estimates [total as shown among liabilities, if satisfied that case estimates are adequate]	......	
Furniture, equipment, automobiles and leasehold improvements, less $...... depreciation and amortization [on income tax basis]	......	
Other non-admitted assets [if appropriate under generally accepted accounting principles and after appropriate allowance for losses, if needed—major items to be detailed]	......	
Income tax effects applicable to:		
Restoration of acquisition costs	......	
Net unrealized gain on investments	......	......
Stockholders' equity, (or members' surplus) as adjusted		$......
Consisting of:		
Capital stock		$......
Capital in excess of par value		......
Retained earnings:		
Appropriated for contingencies—prescribed or voluntary	......	
Unappropriated	......	
Unrealized appreciation of investments net of Federal income taxes	......	......
		$......

ment of Adjusted Net Income and Statement of Adjusted Stockholders' (Members') Equity. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the accompanying financial statements present fairly the admitted assets, liabilities and surplus of X Company at December 31, 19___, and the results of its operations and changes in surplus for the year then ended, in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of (blank), applied on a basis consistent with that of the preceding year. These practices vary in some respects from generally accepted accounting principles (See Note 1 to financial statements).

Also, in our opinion, the supplemental Statements of Adjusted Net Income and Adjusted Stockholders' (Members') Equity present fairly the adjusted stockholders' (members') equity at December 31, 19___, and the adjusted net income for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

In those situations in which the supplemental data is included in a footnote rather than in supplemental statements, the last sentence of the auditors' opinion would read as follows:

Also, in our opinion, the supplemental data included in Note___ present fairly the adjusted stockholders' (members') equity as of December 31, 19___ and the adjusted net income for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

In those instances where the effects of the variances have not been determined by the insurance companies and are not reasonably determinable, the committee believes that the following independent auditors' opinion is illustrative of one that will substantially meet the objectives of Statement No. 33.

We have examined the Statement of Admitted Assets, Liabilities and Surplus of XYZ Insurance Company as at December 31, 19___ and the related Statements of Income and Changes in Surplus for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the accompanying financial statements present fairly the admitted assets, liabilities and surplus of XYZ Insurance Company at December 31, 19___, and the results of its operations and changes in surplus for the year then ended, in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of (blank), applied on a basis consistent with that of the preceding year. These practices vary in some respects from generally accepted accounting principles (See Note 1 to financial statements).

An illustration of Note (1) as it might appear is as follows:

Notes to Financial Statements

(1) The accompanying financial statements have been prepared in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of (blank) which vary in some respects from accounting principles followed by business enterprises in general in determining financial position and results of operations. Such significant differences include:

(a) No provision has been made for Federal income taxes on unrealized appreciation of stocks which are carried at market value; (b) acquisition costs, such as commissions, premium taxes and other items, are charged to current operations as incurred, whereas related premium income is taken into earnings on a pro rata basis over the periods covered by the policies; (c) certain assets designated as "non-admitted assets" (principally direct and reinsurance premiums "overdue," and office furniture and equipment) are charged off against income or surplus; (d) reserves are provided over related funds held for the excess of unearned premiums and losses recoverable on business reinsured with companies not authorized to do business in the state; (e) on certain lines of insurance reserves in excess of the amounts considered adequate by the company have been provided in accordance with statutory requirements, and (f) realized investment gains and losses are included in net income from operations, while unrealized gains and losses are credited or charged directly to surplus.

The effect of such differences on the accompanying financial statements is not reasonably determinable (or, as an alternative to the words "on the accompanying financial statements," on the stockholders' equity and net income).

It should be emphasized that the items mentioned in this Note are included only for purposes of illustration. In a particular case, some of the items may not apply, or others may be applicable. Any items mentioned in a note as representing differences between the two bases of accounting should have application in the particular case.

In those cases where supplemental statements are furnished, the following sentence should be included:

> The effect of the variance referred to above is shown in the accompanying supplemental Statements of Adjusted Net Income and Adjusted Stockholders' (Members') Equity.

In those cases where the supplemental data is to be included in the note, the concluding paragraph of Note (1) may read:

> If the accompanying financial statements had been prepared in accordance with generally accepted accounting principles, Earned Surplus at December 31, 19___, would be $________; total Stockholders' Equity would be $________; and Net Income for the year would have been $________.

In the above situation, of course, no reference would be made in the scope paragraph to supplemental statements.

In connection with filings with the SEC, the data must be included in tabular form in a note or otherwise, as indicated previously.

GLOSSARY of TERMS
FIRE and CASUALTY INSURANCE

ABSTRACT—Form prepared containing basic data shown on the policy. Copies of the abstract may be used by the accounting, statistical, payroll audit and inspection departments.

ACCIDENT YEAR—The calendar year in which the accident or loss occurred.

ACCOUNT CURRENT OR AGENT'S ACCOUNT—A statement usually prepared by the agent for his month's business showing for each premium transaction: the policy number, sometimes the insured's name, the premium or return premium in the appropriate column according to rate of commission, postage and other charges and the balance due either to the company or to the agent.

ACCRUAL OF DISCOUNT ON BONDS—Adjustment of the purchase price of bonds (purchased at less than par value) to increase the value to par at maturity date. The adjustment is either calculated on a pro rata basis or so as to yield the effective rate of interest at which the purchase was made (scientific basis).

ACQUISITION COSTS—Expenses incurred in acquiring business includes commissions to agents and brokers and other acquisition, field supervision and collection expenses. Usually also considered to include premium taxes.

ADDITIONAL PREMIUM—Premium due from the insured arising from an endorsement.

ADMITTED ASSETS—See Assets, admitted.

AGENCY COMPANY—An insurance company whose business is produced through a network of agents as distinguished from a direct writing company whose business is produced by company employees.

AGENCY REINSURANCE—Reinsurance assumed or ceded for an insurer by one of its agents who usually handles the details of writing the policies and collecting or paying the premiums. For example, on very large risks the agent frequently issues only one policy to the insured and then obtains reinsurance from other companies to reduce the exposure of the insurer to a desired level.

AGENCY SYSTEM—System of producing business through a network of agents. Such agents have a contract to represent the company and are of three classes: local, regional and general. These agents are compensated at differing rates of commission and general agents have much greater responsibilities and duties than local and regional agents.

AGENTS' BALANCES—Premium balances, less commissions payable thereon, due from agents and brokers.

AGGREGATE EXCESS OF LOSS—Stop loss agreement designed to prevent the ceding company's loss from exceeding a specific predetermined limit. For example, if under an agreement indemnifying a company against losses in excess of a 70 per cent loss ratio, the ceding company's loss ratio exceeds 70 per cent, then recovery will be made from the reinsurer of the necessary amount to reduce the loss ratio to 70 per cent.

ALLOCATED CLAIM OR LOSS EXPENSES—See claim or loss expenses.

AMORTIZATION OF PREMIUMS ON BONDS—Adjustment of the purchase price of bonds (purchased at more than par value) to decrease the value to par at maturity or call date. The adjustment is either calculated on a pro rata basis or so as to yield the effective rate of interest at which the purchase was made (scientific basis).

ANNUAL PRO RATA—A basis used for calculation of unearned premiums involving the assumption that the average date of issue of all policies written during the year is the middle of the year.

ANNUAL STATEMENT (CONVENTION STATEMENT OR CONVENTION FORM)—Statement furnishing full and complete information regarding the company's condition and affairs at December 31 of each year required by Insurance Departments of the various states in which a company is authorized to transact business. This annual statement must be filed on the prescribed form with the various Insurance Departments by March 1 of the following year.

APPLICATION—Request for insurance submitted to the insurer by or on behalf of the insured. The application usually includes sufficient facts for the insurer to determine whether or not it wishes to accept the risk. In some lines of insurance the terms daily and application are used synonymously.

ASSETS, ADMITTED—Assets stated at values at which they are permitted to be reported in the annual statement filed with the various Insurance Departments.

ASSETS, LEDGER—Assets which are recorded on a company's general ledger. Usually include investments, cash, agents' balances or uncollected premiums and reinsurance recoverable.

ASSETS, NON-ADMITTED—Assets, or portions thereof, which are not permitted to be reported as admitted assets in the annual statement filed with the various Insurance Departments. Non-admitted assets are those specifically defined by the insurance laws of the various states and also all other assets not allowed as admitted assets. Major non-admitted assets are: excess of book over statement value of investments, agents' balances or uncollected premiums over three months due and furniture, fixtures, supplies, equipment and automobiles.

ASSETS, NON-LEDGER—Assets which are not recorded on a company's general ledger. Usually include excess of statement value of stocks and bonds respectively over book value and accrued interest or other accrued income on investments.

ASSURED OR INSURED—The person whose life or property is insured. The party in whose favor a policy stands.

AUDIT PREMIUMS—Earned premiums determined from data developed by periodic audits of insureds' records or from periodic reports submitted by insureds. Such audits are made and such reports are submitted either monthly, quarterly, semi-annually or annually.

AUTOMATIC TREATY—Usually a pro rata reinsurance treaty under which the reinsurer is committed to accept from the ceding company a fixed share of each risk or of certain risks. Each party has a fixed obligation; the ceding company is obligated to cede and the reinsurer is obligated to accept.

BORDEREAU—Detailed listings of premiums and/or loss transactions usually prepared monthly and rendered to interested parties. Frequently rendered by ceding companies to reinsurers and by large general agents to companies.

BROKER—A licensed representative who places the insurance of his client with a company. The compensation for his services consists of commission paid to him by the insurance company. He is not an agent of the company and the commission he receives is usually lower than that of an agent who legally represents the company.

CANCELLATION—A complete termination of an existing policy prior to expiration.

CASE BASIS—Reserves for losses (claims) or loss expenses based on individual estimates of the value of each unpaid loss (claim).

CASE RESERVE—The estimated amount of future loss payments which are still to be made on an outstanding claim.

CATASTROPHE—Conflagration, earthquake, windstorm, explosion and other similar events resulting in substantial losses. Catastrophe losses (the whole loss of an insurance company arising out of a single catastrophic event) are usually reinsured under excess of loss treaties in order to limit any one such loss to a specific dollar amount.

CEDING COMPANY—The original or primary insurer who reinsures with another company who is called the reinsurer.

CESSION—The unit of insurance passed on to the reinsurer by the primary or ceding company. Frequently, under certain types of reinsurance treaties, each transaction is given a number called a cession number.

CLAIM OR LOSS EXPENSES—The expenses incurred in the investigation, adjustment and settlement of losses. There are two types of claim or loss expenses: allocated and unallocated; however, there are no generally accepted definitions of these two terms. Allocated claim or loss expense is frequently considered to include expenses incurred in settling losses that can be attributed to specific losses including such items as actual court costs, attorneys' fees, medical examinations, independent adjusters' fees, etc.

Unallocated claim or loss expense is frequently considered to include expenses incurred in settling losses which cannot be attributed to specific cases including salaries of company loss department employees and all other direct and overhead expenses of the loss department.

CLAIM OR LOSS FILES—All data relating to each loss or claim are placed together in a folder or stapled together, etc., and are referred to as the loss or claim file.

CLAIMS (LOSSES)—Synonymous terms. Death, injury, destruction, or damage in such a manner as to charge the insurer with a liability under the terms of a policy. The primary reason for the existence of insurance carriers is to pay claims and/or losses arising from the contingencies insured against.

CONTINGENT COMMISSION—A profit-sharing commission which is paid or received in addition to the ordinary basic commission. The amount of profit is calculated in accordance with the terms of the contract which usually provides that the earned premiums for the period be reduced by incurred losses and commissions and a stipulated allowance for expenses. The contingent commission is calculated at a percentage of such profit.

CONTRIBUTIONS TO PREMIUM IN FORCE—Net change in premiums in force for the period. Net original premiums written during the period (total original premiums less original return premiums).

CONVENTION STATEMENT OR CONVENTION FORM—See annual statement.

DAILY REPORT OR DAILY—The copy of the policy retained by the company or forwarded to the company by the agent. The daily does not include all of the standard provisions included in the policy, as this is unnecessary, but all special provisions and endorsements are attached to the daily. This is, of course, one of the basic documents in an insurance office.

DEVELOPMENT (RUN-OFF) OF LOSS RESERVES—Comparison of the loss reserves outstanding at any particular date with the total of the payments on such losses from the reserve date to the development date plus the estimated reserves for losses still unpaid at the date of the development.

DIFFERENCES—Term applied to the differences developed as a result of comparisons made of "accounts current" rendered by agents with transactions shown on the company's records. Such differences very frequently occur because the agent and the company each use a different cutoff date and also because of errors and omissions by either the company or the agent.

DIRECT PREMIUMS—All premiums (less return premiums) arising from policies issued to provide the primary insurance on a given hazard.

DIRECT WRITING COMPANY—An insurance company whose business is produced by company employees as distinguished from an agency company whose business is produced by agents.

EARNED PREMIUM—The pro rata portion of the premium applicable to the expired period of the policy.

ENDORSEMENT—Documentary evidence of a change in an existing policy resulting in either an additional premium, a return premium or no premium adjustment.

EQUITY IN THE UNEARNED PREMIUM RESERVE—Prepaid acquisition expenses applicable to unearned premiums. Pursuant to accounting practices prescribed for insurance companies, premiums are recorded as earned ratably over the terms of the policies issued although related commissions, premium taxes and other acquisition expenses are charged to income as incurred. This departure from the basic accounting concept of matching income and expense results in an equity in unearned premiums at any date to the extent of the prepaid acquisition expenses applicable to such unearned premiums. There is another concept concerning the equity in the unearned premium reserve based on the premise that the unearned premium reserve exceeds the amount required to pay future losses and expenses on all unexpired policies; under this concept any anticipated profit on the run off of the unexpired policies is included in the equity.

EXCESS OF LOSS TREATY—A type of reinsurance treaty used extensively on casualty lines and, to an increasing extent on fire lines, providing that the reinsurer pays all, or a specified percentage, of a loss arising from a particular occurrence or event (frequently of a more or less catastrophic nature) in excess of a fixed amount and up to a stipulated limit. Such treaties do not usually apply to specific policies but to aggregate losses incurred under all policies subject to the particular hazards reinsured. The premium is usually a percentage of the net premiums written by the carrier for the hazards subject to such reinsurance.

FACULTATIVE—Reinsurance arrangements under which each risk to be reinsured is offered to and is either accepted or rejected by the reinsurer. So called facultative reinsurance arrangements are therefore only permissive and do not obligate the ceding company to cede or the reinsurer to accept.

FUNDS HELD BY COMPANY UNDER REINSURANCE TREATIES—A liability account used in connection with reinsurance agreements. When a company obtains a deposit from a reinsurer or withholds a portion of the premiums due as a guarantee that a reinsurer will meet its loss and other obligations, then this account is used to record such liability.

FUNDS HELD BY OR DEPOSITED WITH CEDING REINSURERS—An asset account used in connection with reinsurance agreements. The reinsurer uses this account to record deposits made with ceding companies or withholdings by ceding companies of a portion of premiums due as a guarantee that the reinsurer will meet its loss and other obligations. This account is also used when pools and associations withhold funds from reinsurers for the same purposes mentioned above and then the member companies use this asset account and the liability account, "Funds held by company under reinsurance treaties" to record this information on their books.

GROSS IN FORCE—Aggregate premiums from all policies on direct and assumed business recorded prior to the specified date which have not yet expired or been canceled.

GROSS NET PREMIUM INCOME—As used in reinsurance contracts, gross written premiums less return premiums and reinsurance premiums. This term has the same meaning as "net written premiums" or "net premiums" in the United States. In Europe the term "net premiums" refers to gross premiums received less return premiums, reinsurance premiums and commissions paid thereon.

GROSS PREMIUMS—Following annual statement usage, direct premiums plus reinsurance assumed premiums (both net of return premiums). Also defined as: premiums written or received but before deduction of return premiums.

HAZARD—The risk or peril or source of risk insured against. This term is frequently used interchangeably with the terms risk and peril.

INCURRED LOSS RATIO—Ratio calculated by dividing incurred losses by earned premiums.

INCURRED LOSSES (CLAIMS)—Losses paid or unpaid for which the company has become liable during the period. Incurred losses for a period are calculated by adding unpaid losses at the end of the period to losses paid during the period and subtracting unpaid losses at the beginning of the period.

INSTALLMENT PREMIUMS—Premiums payable on a periodic basis rather than in a lump sum at the inception or effective date of the policy.

INSURABLE VALUE—The stated value in the insurance contract. It may be the cash or market value, the declared value or the replacement value.

INSURANCE EXPENSE EXHIBIT—A supplement to the annual statement to be filed with each Insurance Department usually by May 1 rather than on March 1, the day on which the annual statement is due to be filed. The net gain or loss from underwriting for each line of business written by the company during the year reported on is shown on this exhibit.

INTER-INSURANCE EXCHANGE OR RECIPROCAL—An unincorporated aggregation of individuals or firms called subscribers who exchange insurance through an attorney in fact. Each subscriber is therefore both an insurer and an insured.

INTERMEDIARY—A reinsurance broker who negotiates reinsurance contracts on behalf of the reinsured (ceding company) with the reinsurer.

INVESTMENT EXPENSES—According to the uniform expense regulation, all expenses incurred wholly or partially in connection with the investing of funds and the obtaining of investment income.

LIABILITIES, LEDGER—Liabilities recorded on the company general ledger.

LIABILITIES, NON-LEDGER—Liabilities not recorded on the company general ledger but available from other basic records or sources.

Usually include accruals or provisions for unearned premiums, unpaid losses, loss expenses, contingent commissions, taxes, other expenses, dividends declared and unpaid, statutory loss reserves and unauthorized reinsurance.

LINE—Type of insurance. In relation to the amount which an insurance company accepts on a risk: (1) the limit which a company has fixed for itself as maximum exposure on a class of risk, (2) the actual amount which the company has in fact accepted on a single risk.

LOSS OR CLAIM EXPENSES—See claim or loss expenses.

LOSS OR CLAIM FILES—See claim or loss files.

LOSS RATIOS—Expression in terms of ratios of the relationship of losses to premiums. Two ratios in common usage are: (1) paid loss ratio—paid losses divided by written premiums or earned premiums, (2) incurred loss ratio—incurred losses divided by earned premiums.

LOSSES (CLAIMS)—See claims.

LOSSES INCURRED BUT NOT REPORTED (IBNR)—Losses resulting from accidents or occurrences which have taken place but on which the company has not yet received notices or reports of loss.

LOSSES OR CLAIMS INCURRED—See incurred losses (claims).

LOSSES OUTSTANDING (ALSO REFERRED TO AS LOSS RESERVE)—The estimated amount of unpaid losses for which the company is liable.

LOSSES, REPORTED—Losses resulting from accidents or occurrences which have taken place and on which the company has received notices or reports of loss.

MONTHLY PRO RATA—A basis used for calculation of unearned premiums involving the assumption that the average date of issue of all policies written during any month is the middle of that month.

MUTUAL COMPANY—Co-operative nonprofit association of persons whose purpose is to insure themselves against various risks.

NET PREMIUMS—Premiums written or received on direct and assumed business less return premiums and less reinsurance ceded premiums.

NON-ADMITTED ASSETS—See assets, non-admitted.

NON-LEDGER ASSETS—See assets, non-ledger.

NON-LEDGER LIABILITIES—See liabilities, non-ledger.

ORIGINAL PREMIUM—The premium for the full term of the policy. In case the policy has been changed, then the original premium can be determined by multiplying the amount currently insured by the latest premium rate shown on the policy or an endorsement thereof.

PAID LOSSES—Actual disbursements for losses during the period.

PERIL—Classification of loss occurrences insured against, such as fire, windstorm, collision, hail, bodily injury, property damage, loss of profits, etc.

POLICY DIVIDENDS—Payments made or credits extended to the insured by the company, usually at the end of the policy year, which result in reducing the net insurance cost to the policyholder. Such dividends may be paid in cash to the insured or applied by the insured as a reduction of the premium due for the next policy year.

POLICYHOLDERS' SURPLUS (SURPLUS AS REGARDS POLICYHOLDERS)—The total capital funds as shown on the annual statement. Consists of capital, if any, unassigned funds (surplus) and any special surplus funds which are not in the nature of liabilities.

POLICY YEAR—The calendar year in which a policy became effective.

POOLING—Practice of sharing all business of an affiliated group of insurance companies between the members of the group. All premiums written by the subsidiary companies are customarily ceded to or reinsured by the parent company; then, after provision for any required outside reinsurance, the total premiums are in turn ceded back to the subsidiaries in agreed ratios. Losses, loss expenses, commissions and other underwriting and operating expenses (excluding investment expenses) are similarly treated with the net result that each of the members of the affiliated group will share in the total business of the group (but usually in varying percentages) and all will achieve similar underwriting results.

PREMIUM—The consideration paid for a contract of insurance.

PORTFOLIO REINSURANCE—Reinsurance on a bulk basis. Occurs frequently at the inception or termination of a reinsurance treaty. Also used as a means by which a company may retire from a particular agency or territory or from the insurance business entirely. All business in force of the type, line or class which the company desires to reinsure is reinsured at a particular moment of time usually by the payment of the unearned premium reserve to the reinsurer less an agreed commission. The reserve for unpaid losses at the time of the transaction may also be paid over to the reinsurer and the reinsurer will then be charged with all loss payments made after the effective date.

PREMIUM EARNED—See earned premiums.

PREMIUM TAXES—Taxes levied, at rates varying from 1½ per cent to 4 per cent, on insurance companies by the various states on premiums written.

PREMIUMS IN FORCE—Aggregate premiums from all policies recorded prior to the specified date which have not expired or been canceled.

PROOF OF LOSS—A sworn statement furnished by the insured to the carrier setting forth the amount of loss claimed. This form, which is usually used in the settlement of first-party losses, includes the date and description of the occurrence, amount of loss claimed, interested insurers, etc.

PRO RATA REINSURANCE—The reinsured and the reinsurer participate in the premiums and losses on every risk that comes within the scope of the agreement at a fixed and certain proportion.

QUOTA SHARE REINSURANCE—A form of pro rata reinsurance. A reinsurance of a certain percentage of all the business or certain classes of or parts of the business of the reinsured. For example, a company might reinsure under a quota share treaty 50 per cent of all of its business or 50 per cent of its automobile business.

RECIPROCAL OR INTER-INSURANCE EXCHANGE—See inter-insurance exchange or reciprocal.

REINSURANCE—A contract in which the reinsurer (the first party) in consideration of a premium agrees to indemnify the reinsured (the second party) against a risk insured by the reinsured under a policy in favor of the insured (a third party). The reinsured may be referred to as the original or primary insurer or the ceding company.

REINSURANCE ASSUMED PREMIUMS—All premiums (less return premiums) arising from policies issued to assume the liability, in whole or in part, of another insurance company which is already covering the risk with a policy.

REINSURANCE, AUTHORIZED—Reinsurance placed with companies authorized to transact business in the state of filing.

REINSURANCE, UNAUTHORIZED—Reinsurance placed with companies not authorized to transact business in the state of filing.

REINSURANCE CEDED PREMIUMS—All premiums (less return premiums) arising from policies or coverage purchased from another insurance company for the purpose of transferring the liability, in whole or in part, assumed from direct or reinsurance assumed policies.

REINSURANCE IN FORCE—Aggregate premiums on all reinsurance ceded business recorded prior to the specified date which have not yet expired or been canceled.

RETURN PREMIUM—A premium refund due the insured, arising from an endorsement or cancellation.

RETENTION—The net amount of any risk which a company keeps for its own account.

RETROCESSION—A reinsurance of reinsurance assumed. For example: A accepts reinsurance from B and then in turn reinsures with C a whole or part of the reinsurance assumed from B. The reinsurance ceded to C by A is called a retrocession.

RETROSPECTIVE PREMIUM—Premium determined after expiration of the policy based on the loss experience under the policy. The original premium charged on such policies is referred to as the standard premium.

RISK—See hazard.

STATUTORY LOSS RESERVES—The amount by which reserves required by law on bodily injury and workmen's compensation losses exceed the case basis loss and loss expense reserves carried by a company for such losses.

SALVAGE—Amount received by an insurer from the sale of property (usually damaged) on which he has paid a total loss to the insured. For example, when an insurer has paid the insured the actual cash value of an automobile damaged (usually extensively) by collision, then the insurer takes title to and sells the damaged automobile for his own account. Salvage is applied by insurance companies to reduce the amount of loss paid.

SPREAD LOSS TREATY—A treaty on an excess of loss basis designed to pay certain losses over a given or stipulated amount and to average such losses out over a period of years. Five years is the usual period, with the premium adjustable within fixed minimum and maximum limits according to the company's experience. Such a treaty protects the ceding company against shock losses and spreads their cost over a five-year period subject, of course, to the maximum and minimum premium each year.

STATUTORY—Relating to the laws of the federal or of a state government.

STOCK COMPANIES—Corporations organized for profit to offer insurance against various risks.

STOP LOSS REINSURANCE—Type of excess reinsurance also called excess of loss ratio. Provides that the insurer will suffer the loss in its entirety until the total amount of the loss is such that the loss ratio (losses divided by premiums) exceeds an agreed loss ratio, then the reinsurer will reimburse the insurer the sum that is necessary to bring the loss ratio down to the agreed percentage.

SUBROGATION—The statutory or legal right of an insurer to recover from a third party who is wholly or partially responsible for a loss paid by the insurer under the terms of a policy. For example, when an insurer has paid the insured for loss sustained to his automobile as the result of a collision, the insurer may collect through the process of subrogation from the person whose automobile caused the damage. Subrogation recoveries are treated as reductions of the losses paid.

SURPLUS AS REGARDS POLICYHOLDERS—See policyholders' surplus.

SURPLUS TREATY REINSURANCE—A treaty on a pro rata basis reinsuring surplus liability on various risks. The reinsurer shares the gross lines of the ceding company. The amount reinsured varies with different classes of risks and according to the net retention which the ceding company wishes to retain for its own account. Ceding companies very frequently have several layers of surplus treaties so that they may accommodate very large risks, as usually the reinsurer's participation in any one surplus treaty is limited to a certain multiple of the ceding company's retention. Premiums and losses are shared by the reinsurer and the ceding company on a pro rata basis in proportion to the amount of the risk insured or reinsured by each. This is one of the oldest forms of treaty reinsurance and is still in common use in fire reinsurance.

TREATY—A contract of reinsurance.

UNALLOCATED CLAIM OR LOSS EXPENSE—See claim or loss expenses.

UNEARNED PREMIUM—The pro rata portion of the premium in force applicable to the unexpired period of the policy term.

UNEARNED PREMIUM RESERVE—The estimated aggregate amount an insurer would be obligated to pay policyholders as return premiums for the unexpired terms of policies, if it should cancel every policy in force.

UNDERWRITING—The assumption of risk for designated loss or damage on consideration of receiving a premium. Usually also considered to embrace the determination of the acceptability of risks to be insured and of the proper premium therefor.

APPENDIX A

Statement of Position

Revision of Form of Auditor's Report

AUDITS OF FIRE AND CASUALTY INSURANCE COMPANIES

July 1974

Issued by Auditing Standards Division
American Institute of Certified Public Accountants

NOTICE TO READERS

The American Institute of Certified Public Accountants has issued a series of industry-oriented audit guides that present recommendations on auditing procedures and auditors' reports and in some instances on accounting principles, and a series of accounting guides that present recommendations on accounting principles. Based on experience in the application of these guides, AICPA task forces may from time to time conclude that it is desirable to change a guide. A Statement of Position is used to revise or clarify certain of the recommendations in the guide to which it relates. A Statement of Position represents the considered judgment of the responsible AICPA task force.

To the extent that a Statement of Position is concerned with auditing procedures and auditors' reports, its degree of authority is the same as that of the audit guide to which it relates. As to such matters, members should be aware that they may be called upon to justify departures from the recommendations of the task force.

To the extent that a Statement of Position relates to standards of financial accounting or reporting (accounting principles), the recommendations of the task force are subject to ultimate disposition by the Financial Accounting Standards Board. The recommendations are made for the purpose of urging the FASB to promulgate standards that the task force believes would be in the public interest.

Insurance Auditing Task Force

RANDOLPH H. WATERFIELD, JR., *Chairman*
CORMICK L. BRESLIN
FRANK A. BRUNI
NORBERT A. FLOREK
JOHN E. HART
PAUL W. HORSLEY
JOHN L. MCDONOUGH, JR.
PHILIP C. PRESTON
RICHARD J. SENNEFF
RICHARD D. WAMPLER II

AICPA Staff:
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JAMES M. CASEY

Audits of Fire and Casualty Insurance Companies

The AICPA issued in 1966 the industry audit guide, *Audits of Fire and Casualty Insurance Companies.* Chapter 9 of that guide included recommendations on the form of the auditor's report. In December 1972, the AICPA issued an industry audit guide entitled *Audits of Stock Life Insurance Companies.* The recommendations on the form of the auditor's report in that guide varied from the recommendations set forth in the fire and casualty audit guide. It is the considered judgment of the AICPA Insurance Auditing Task Force that the portion of chapter 9 on pages 58 through 64 of the fire and casualty audit guide that deals with the form of the auditor's opinion should be revised; that portion is superseded by this Statement of Position.

The preferable method of financial statement presentation to avoid the need for qualification of the auditor's report is to present the financial statements in accordance with generally accepted accounting principles.

When the financial statements of fire and casualty insurance companies, used for purposes other than filing with regulatory authorities, have been prepared in conformity with regulatory practices, the independent auditor should follow the requirement of section 544.02 of SAS No. 1 that—

> . . . material variances from generally accepted accounting principles, and their effects, should be dealt with in the independent auditor's report in the same manner followed for companies which are not regulated. Ordinarily, this will require either a qualified or an adverse opinion on such statements. However, an adverse opinion may be accompanied by . . . [an opinion] . . . on any supplementary data fur-

nished which are fairly presented in conformity with generally accepted accounting principles.

Independent auditors' reports which might be used are illustrated below.

Effects of Variances From Generally Accepted Accounting Principles Have Been Determined

Qualified Opinion. When the financial statements of a fire and casualty insurance company have been prepared in conformity with regulatory practices, and the effects of the variances from generally accepted accounting principles are sufficiently material to require a qualified opinion, the auditor's report might be worded as follows:

> We have examined the balance sheet of X Company as of December 31, 19__, and the related statements of income, changes in surplus and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.
>
> The Company presents its financial statements in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of __________. The effects on the accompanying financial statements of the variances between such practices and generally accepted accounting principles are described in Note X.[1]
>
> In our opinion, except for the effects of the matters referred to in the preceding paragraph, the aforementioned financial statements present fairly the financial position of X Company at December 31, 19__, and the results of its operations and changes in its financial position for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

[1] If the effects of the variances are not described in a note, they should be set forth in this paragraph.

If a statement of changes in financial position on a statutory basis is not presented, the omission should be dealt with in accordance with sections 545.04 and .05 of SAS No. 1.

Adverse Opinion. When the financial statements of a fire and casualty insurance company have been prepared in conformity with regulatory practices, and the effects of the variances from generally accepted accounting principles are so material that, in the independent auditor's judgment, a qualified opinion is not justified, an adverse opinion will be required. The adverse opinion will usually be followed by an opinion on any supplementary data presented in conformity with generally accepted accounting principles. When such data are presented separately, rather than in notes to the financial statements, the scope paragraph of the independent auditor's report should be expanded to include references to supplementary data and a second paragraph should be added referring to the variances from generally accepted accounting principles worded as in the prior example. The opinion paragraph might be worded as follows:

> It is our opinion that, because of the materiality of the effects of the differences between generally accepted accounting principles and the accounting practices referred to in the preceding paragraph, the aforementioned financial statements do not present fairly the financial position of X Company at December 31, 19___, or the results of its operations or changes in its financial position for the year then ended, in conformity with generally accepted accounting principles. It is our opinion, however, that the statements of adjustments to arrive at stockholders' (members') equity and net income present fairly stockholders' (members') equity at December 31, 19___, and net income for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

When the supplementary data are included in a note to the financial statements, the last sentence of the opinion would read as follows:

> It is our opinion, however, that the supplementary data included in Note X present fairly the stockholders' (mem-

> bers') equity at December 31, 19__, and net income for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Variances Not Affecting All Financial Statements. When the effects of variances from generally accepted accounting principles are material to one or more but not all of the financial statements, the auditor's report may include an unqualified opinion on the statements not so affected.

Effects of Variances From Generally Accepted Accounting Principles Have Not Been Determined

When the financial statements of a fire and casualty insurance company have been prepared in conformity with regulatory practices, and the effects of variances from generally accepted accounting principles have not been determined by the company, the auditor should generally be able to reasonably estimate whether such effects (a) would be immaterial so as to permit issuance of an unqualified opinion, (b) would be sufficiently material to require issuance of a qualified opinion, or (c) would be so material as to require issuance of an adverse opinion. In reporting, the auditor should then follow the appropriate form recommended above. If the auditor is not able to reasonably estimate the effects of variances, he should disclaim an opinion; his report might read as follows:

(Standard scope paragraph)

> The Company presents its financial statements in conformity with the accounting practices prescribed or permitted by the Insurance Department of the State of __________. The variances between such practices and generally accepted accounting principles are described in Note X.[2] The effects of such variances on the accompanying financial statements have not

[2] If the variances are not described in a note to the financial statements, they should be set forth in this paragraph.

> been determined. Therefore, we do not express any opinion on the aforementioned financial statements as to fair presentation of financial position or results of operations or changes in financial position in conformity with generally accepted accounting principles.

Opinions on Presentations in Conformity With Regulatory Practices

Section 544.04 of SAS No. 1 states that—

> In instances where the financial statements of regulated companies purport to be primarily presentations in accordance with prescribed accounting regulations, the independent auditor may also be asked to report upon their fair presentation in conformity with such prescribed accounting. There is no objection to the independent auditor's report containing such an opinion provided that the first standard of reporting is also observed by the issuance of a qualified or adverse opinion, as required by the circumstances.

When the auditor is asked to report in this manner, he may do so by adding the following opinion to the concluding paragraph of any prior examples:

> It is our opinion, however, that the aforementioned financial statements present fairly the financial position of X Company at December 31, 19___, and the results of its operations and changes in its financial position for the year then ended in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of ___________, applied on a basis consistent with that of the preceding year.

Effective Date

The Insurance Auditing Task Force recommends that the foregoing reporting be applied with respect to auditors' reports on financial statements of fire and casualty insurance companies for periods ending after September 30, 1974, and encourages earlier application.

APPENDIX B

Auditing Standards Division

Statement of Position

AUDITING PROPERTY AND LIABILITY REINSURANCE

Supplements *Audits of Fire and Casualty Insurance Companies*

October 1982

Prepared by the Reinsurance Auditing and Accounting Task Force
American Institute of Certified Public Accountants

NOTICE TO READERS

This statement of position presents recommendations of the Reinsurance Auditing and Accounting Task Force of the AICPA Insurance Companies Committee regarding the application of generally accepted auditing standards in auditing property and liability reinsurance. This statement of position supplements the industry audit guide, *Audits of Fire and Casualty Insurance Companies*. It represents the considered opinion of the AICPA Reinsurance Auditing and Accounting Task Force on the best auditing practice in the industry and has been reviewed by members of the AICPA Auditing Standards Board for consistency with existing auditing standards. AICPA members may have to justify departures from the recommendations in this statement if their work is challenged.

Auditing Property and Liability Reinsurance

Introduction

1. Reinsurance is the assumption by one insurer of all or part of a risk originally undertaken by another insurer. Reinsurance is not transacted directly with the general public, but, instead, between insurance companies. In the United States there are basically three types of reinsurance entities: professional reinsurers, reinsurance departments of primary insurance companies, and various groups or syndicates of insurers referred to as reinsurance pools or associations.

- *Professional reinsurers*, while likely permitted by their charters and licenses to operate as primary insurance companies, engage almost exclusively in reinsurance.
- *Reinsurance departments* of primary insurance companies function as units of primary insurers and engage in the reinsurance business.
- *Reinsurance pools* (also referred to as associations or syndicates) may be organized to provide their members with reinsurance protection and management for certain specialized, high-risk coverage or with general access to the reinsurance market for traditional lines of business.

In addition, reinsurance intermediaries (including brokers, agents, managing general agents, and similar entities) facilitate the business of reinsurance by bringing together reinsurance purchasers and sellers. The functions of reinsurance entities may include underwriting, designing and negotiating the terms of reinsurance, placing reinsurance, accumulating and reporting transactions, distributing premiums, and collecting and settling claims.

2. Major reasons for insurance companies to enter reinsurance contracts are to—

a. Reduce their exposure on particular risks or classes of risks.

b. Protect against accumulations of losses arising from catastrophes.

c. Reduce their total liabilities to a level appropriate to their premium volumes and amounts of capital.

d. Provide financial capacity to accept risks and policies involving amounts larger than could otherwise be accepted.

e. Help stabilize operating results.

f. Obtain assistance with new products and lines of insurance.

For similar reasons, reinsurers may at times reinsure their own risks with other insurance and reinsurance companies, a practice known as retrocession.

3. Reinsurance may be transacted under broad, automatic contracts called "treaties," which are usually of long duration and which cover some portion of a particular class of business underwritten by the insurers. Reinsurance may also be transacted under "facultative" agreements, which cover specific individual risks and require the insurer and reinsurer to agree on terms and conditions of reinsuring each risk. Reinsurance may either be "pro rata," in which the reinsurer and the insurer share proportionately in the premiums and losses, or "excess," in which only the insurer's losses above a fixed point, known as the "retention," are reinsured. (For a description of the various types of reinsurance transactions, see the AICPA Industry Audit Guide, *Audits of Fire and Casualty Insurance Companies*, pages 5–8.)

4. In ceding all or part of a risk the "ceding company" does not discharge its primary liability to its insureds. The ceding company remains fully liable for the face amount of the policy issued. Through reinsurance, the ceding company reduces its maximum exposure in the event of loss by obtaining the right to reimbursement from the "assuming company" for the reinsured portion of the loss.

5. The accounting entries for reinsurance ceded transactions are the opposite of the entries that arise from direct business. The amounts for reinsurance transactions are usually netted against the

related accounts in financial statements. FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, describes in paragraph 38 the accounting for ceded reinsurance:

> Amounts that are recoverable from reinsurers and that relate to paid claims and claim adjustment expenses shall be classified as assets, with an allowance for estimated uncollectible amounts. Estimated amounts recoverable from reinsurers that relate to the liabilities for unpaid claims and claim adjustment expenses shall be deducted from those liabilities. Ceded unearned premiums shall be netted with related unearned premiums. Receivables and payables from the same reinsurer, including amounts withheld, also shall be netted. Reinsurance premiums ceded and reinsurance recoveries on claims may be netted against related earned premiums and incurred claim costs in the income statement.[1]

6. The accounting entries for reinsurance assumed normally parallel those for direct insurance. However, the extent of the detail in the information provided to the assuming company by the ceding company or the reinsurance intermediary can vary significantly regarding—

a. Timeliness of the information submitted.

b. Detail of information relating to policies, claims, unearned premiums, and loss reserves.

c. Annual statement line-of-business classification.

d. Foreign currency translation information on business assumed from companies domiciled in foreign countries ("alien companies").

Information on losses incurred but not reported (IBNR) and bulk reserves also may be provided by ceding companies under pro rata reinsurance arrangements. Generally no IBNR will be provided on nonproportional (excess) reinsurance arrangements. Based on the quality and comprehensiveness of the detail presented, the information provided may or may not be used by the assuming company.

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[1] FASB Statement No. 60, paragraph 60*f* also specifies the following disclosures regarding reinsurance: "The nature and significance of reinsurance transactions to the insurance enterprise's operations, including reinsurance premiums assumed and ceded, and estimated amounts that are recoverable from reinsurers and that reduce the liabilities for unpaid claims and claim adjustment expenses."

7. FASB Statement No. 60 describes reporting in conformity with generally accepted accounting principles for "payments to insurance companies that may not involve transfer of risk." Similar guidance is provided in FASB Statement No. 5, paragraph 44. Paragraph 40 of FASB Statement No. 60 states—

> To the extent that a reinsurance contract does not, despite its form, provide for indemnification of the ceding enterprise by the reinsurer against loss or liability, the premium paid less the premium to be retained by the reinsurer shall be accounted for as a deposit by the ceding enterprise. Those contracts may be structured in various ways, but if, regardless of form, their substance is that all or part of the premium paid by the ceding enterprise is a deposit, the amount paid shall be accounted for as such. A net credit resulting from the contract shall be reported as a liability by the ceding enterprise. A net charge resulting from the contract shall be reported as an asset by the reinsurer.

Applicability and Scope

8. This statement provides guidance on auditing property and liability reinsurance, including accident and health reinsurance. The following sections describe certain significant aspects of internal accounting control regarding ceded reinsurance and assumed reinsurance and describe the related auditing procedures. SAS No. 1, section 320.31, states, "The establishment and maintenance of a system of internal control is an important responsibility of management." The concept of materiality is inherent in the work of the independent auditor, and the elements of materiality and relative risk underlie the application of generally accepted auditing standards.

Ceded Reinsurance

Internal Controls of the Ceding Company

9. The ceding company should have those internal accounting control procedures that it considers necessary to (*a*) evaluate the financial responsibility and stability of the assuming company (whether the assuming company is domiciled in the United States or in a foreign country) and (*b*) provide reasonable assurance of the accuracy and reliability of information reported to the assuming company and amounts due to or from the assuming company. The

ceding company's control procedures to evaluate the financial responsibility and stability of the assuming company may include—

a. Obtaining and analyzing recent financial information of the assuming company, such as—
   - Financial statements and, if audited, the independent auditor's report.
   - Financial reports filed with the Securities and Exchange Commission (U.S.), Department of Trade (U.K.), or similar authorities in other countries.
   - Financial statements filed with insurance regulatory authorities, with particular consideration of loss reserve development and the quality and liquidity of the company's invested assets.

b. Obtaining and reviewing available sources of information relating to the assuming company, such as—
   - Insurance industry reporting and rating services.
   - Insurance department examination reports.
   - Loss reserve certifications filed with regulatory authorities.
   - Letters relating to the adequacy of internal accounting controls filed with regulatory authorities.
   - Insurance Regulatory Information System results filed with regulatory authorities.

c. Inquiring about the assuming company's retrocessional practices and experience.

d. Inquiring about the general business reputation of the assuming company and the background of its owners and management.

e. Ascertaining whether the assuming company is authorized to transact reinsurance within the ceding company's state of domicile or whether letters of credit or other means of security are provided if the assuming company is not so authorized.

f. Considering the need for and evaluating the adequacy of collateral from the assuming company on certain reinsurance contracts.

10. The ceding company's control procedures relating to the accuracy and reliability of information reported to the assuming company and amounts due to or from the assuming company are generally similar in nature to other control procedures for the recording of insurance transactions. Those control procedures are not addressed in this statement.

Auditing Procedures

11. In the study and evaluation of internal control, the ceding company's independent auditor should review the ceding company's procedures for determining the assuming company's ability to honor its commitments under the reinsurance contract. If the auditor intends to rely on the prescribed procedures, he should perform tests of the ceding company's procedures to obtain reasonable assurance that they are in use and operating as planned.

12. The absence of adequate procedures by the ceding company to determine the assuming company's ability to honor its contractual commitments, or the lack of reasonable assurance that such procedures are in use and operating as planned, may constitute a material weakness in the ceding company's system of internal accounting control.[2] If the auditor decides not to rely on the company's control procedures, whether because of a material weakness or other reasons, he should extend his procedures to evaluate the collectibility of amounts recorded in the financial statements as recoverable from the assuming company. The auditor's extended procedures may include certain of the procedures specified in paragraph 9, but they are not necessarily limited to those procedures. The auditor's inability to perform the procedures he considers necessary, whether as a result of restrictions imposed by the client or by circumstances such as the timing of the work, the inability to obtain sufficient competent evidential matter, or an inadequacy in the accounting records, constitutes a scope limitation that may require the auditor to qualify his opinion or disclaim an opinion (see SAS No. 2, paragraphs 10–13). In such circumstances, the reasons for the auditor's qualification of opinion or disclaimer of opinion should be described in his report.

13. To obtain reasonable assurance that reinsurance contracts are appropriately accounted for, the independent auditor of the

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[2] SAS No. 1, section 320, states, "A material weakness is a condition in which the specific control procedures or the degree of compliance with them do not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions" (as amended by SAS No. 30). SAS No. 20 requires the auditor to communicate to senior management and the board of directors or its audit committee material weaknesses in internal accounting control that the auditor becomes aware of through his examination.

ceding company should perform procedures for selected contracts, selected transactions, and related balances, which include the following:

a. Read the reinsurance contract and related correspondence to—
   - Obtain an understanding of the business objective of the reinsurance contract, and
   - Determine whether the contract should be accounted for according to the provisions of FASB Statement No. 60, paragraph 40 (see paragraph 7, above).

b. Trace entries arising from selected reinsurance contracts to the appropriate records.

c. Trace the selected transactions to supporting documents and test the related receivables and payables.

d. Obtain written confirmation of selected balances. In certain circumstances, confirmation of contract terms may be appropriate.

Assumed Reinsurance

Internal Controls of the Assuming Company

14. A significant element of the assuming company's system of internal accounting control related to assumed reinsurance is appropriate control procedures that the company considers necessary for assessing the accuracy and reliability of data received from the ceding company (whether the ceding company is domiciled in the United States or in a foreign country). Principal control procedures of the assuming company may include—

a. Maintaining an underwriting file with information relating to the business reasons for entering the reinsurance contract and anticipated results of the contract. The underwriting file may include—
   - Historical loss ratios and combined ratios of the ceding company.
   - Anticipated loss ratios under the contract.
   - An indication of the frequency and content of reports from the ceding company.
   - Prior business experience with the ceding company.
   - The assuming company's experience on similar risks.
   - Information regarding pricing and ceding commissions.

b. Monitoring the actual results reported by the ceding company and investigating the reasons for and the effects of significant deviations from anticipated results.

c. Visiting the ceding company and reviewing and evaluating its underwriting, claims processing, loss reserving, and loss reserve development monitoring procedures.

d. Obtaining from the ceding company a special-purpose report by their independent accountant regarding the ceding company's internal accounting controls relating to ceded reinsurance (see SAS No. 30, *Reporting on Internal Accounting Control*, paragraphs 60–61).

15. Additional control procedures of the assuming company may include—

a. Obtaining and analyzing recent financial information of the ceding company, such as—
   - Financial statements and, if audited, the independent auditor's report.
   - Financial reports filed with the Securities and Exchange Commission (U.S.), Department of Trade (U.K.), or similar authorities in other countries.
   - Financial statements filed with insurance regulatory authorities, with particular consideration of loss reserve development.

b. Obtaining and reviewing available sources of information on the ceding company, such as—
   - Insurance industry reporting and rating services.
   - Insurance department examination reports.
   - Loss reserve certifications filed with regulatory authorities.
   - Letters relating to the adequacy of internal accounting controls filed with regulatory authorities.
   - Insurance Regulatory Information System results filed with regulatory authorities.

c. Inquiring about the general business reputation of the ceding company and the background of its owners and management.

Auditing Procedures

16. In the study and evaluation of internal control, the assuming company's independent auditor should review the assuming compa-

ny's procedures for assessing the accuracy and reliability of data received from the ceding company. If the auditor intends to rely on the prescribed procedures, he should perform tests of the company's procedures to obtain reasonable assurance that they are in use and operating as planned.

17. The absence of adequate procedures by the assuming company to obtain assurance regarding the accuracy and reliability of data received from the ceding company, or the lack of reasonable assurance that such procedures are in use and operating as planned, may constitute a material weakness in the assuming company's system of internal accounting control.[3] If the auditor decides not to rely on the company's control procedures, whether because of a material weakness or other reasons, he should extend his procedures to obtain assurance regarding the accuracy and reliability of the data received from the ceding company. The auditor's extended procedures should ordinarily include, but would not necessarily be limited to, one or more of the following:

a. Performing certain of the principal control procedures specified in paragraph 14

b. Visiting the ceding company's independent auditor and reviewing his working papers (See SAS No. 1, section 543.12.)

c. Performing auditing procedures at the ceding company or requesting the independent auditor of the ceding company to perform agreed-upon procedures

d. Obtaining a special-purpose report from the ceding company's independent auditor on design and compliance test of the company's internal controls relating to ceded reinsurance (See SAS No. 44, *Special-Purpose Reports on Internal Accounting Control at Service Organizations.*)

The auditor's inability to perform the procedures he considers necessary, whether as a result of restrictions imposed by the client or by circumstances such as the timing of the work, the inability to obtain sufficient competent evidential matter, or an inadequacy in the accounting records, constitutes a scope limitation that may require the auditor to qualify his opinion or disclaim an opinion (see SAS No.

[3] See footnote 2.

2, paragraphs 10–13). In such circumstances, the reasons for the auditor's qualification of opinion or disclaimer of opinion should be described in his report.

18. To obtain reasonable assurance that reinsurance contracts are appropriately accounted for, the independent auditor of the assuming company should perform procedures for selected contracts, selected transactions, and related balances, which include the following:

a. Read the reinsurance contract and related correspondence to—
- Obtain an understanding of the business objective of the reinsurance contract.
- Determine whether the contract should be accounted for according to the provisions of FASB Statement No. 60, paragraph 40 (see paragraph 7, above).

b. Trace entries arising from selected reinsurance contracts to the appropriate records.

c. Trace the selected transactions to supporting documents and test the related receivables and payables.

d. Obtain written confirmation of selected balances. In certain circumstances, confirmation of contract terms may be appropriate.

Pools, Associations, and Syndicates

19. Participation in reinsurance pools, associations, and syndicates is in some respects similar to reinsurance, and the guidance in paragraphs 14–18 is generally applicable in the audit of an assuming company (participating company). Pools, associations, and syndicates often issue audited financial statements to participating companies, and the auditor of a participating company may use the report of the independent auditor of the pool, association, or syndicate in his examination. Guidance on the auditor's considerations in those circumstances is provided in SAS No. 1, section 543, "Part of Examination Made by Other Independent Auditors."

Reinsurance Intermediaries

20. Reinsurance may be transacted and serviced directly between the ceding and assuming companies or through reinsurance intermediaries (including brokers, agents, managing general

agents, or similar entities). When a reinsurance intermediary is involved, the control procedures of the reinsurance intermediary are an integral part of the reinsurance transaction. The assuming and ceding companies should coordinate their control procedures with those of the reinsurance intermediary.

21. A company may delegate to a reinsurance intermediary the performance of the procedures described in paragraphs 9 and in 14 and 15. The company, however, should have procedures to satisfy itself that the reinsurance intermediary is adequately performing those procedures. The guidance provided the independent auditor in paragraphs 11 and 12 and in 16 and 17 is applicable.

22. In addition to the functions discussed in paragraphs 9 and in 14 and 15, a reinsurance intermediary may be authorized to collect, hold, disburse, and remit funds on behalf of the insurance company. The insurance company should have controls to provide reasonable assurance that the reinsurance intermediary is—

a. Adequately performing those functions.

b. Safeguarding the funds and, if required, appropriately segregating the funds.

c. Settling accounts on a timely basis.

The insurance company may accomplish this by obtaining a special report from the independent auditor of the reinsurance intermediary or by visiting the reinsurance intermediary and reviewing its controls relating to those functions. The auditor of the insurance company should review the company's internal control procedures, and, if he intends to rely on them, he should test the operation of those control procedures. If the auditor decides not to rely on those controls, he should extend his procedures to obtain assurance that the objectives described in *a* – *c* above are met.

Effective Date

23. This statement of position provides for practices that may differ in certain respects from present practices. Accordingly, this statement of position will be effective for examinations made in accordance with generally accepted auditing standards for periods ending on or after December 31, 1983. Earlier application is encouraged.

APPENDIX C

Statement of Financial Accounting Standards No. 60

Accounting and Reporting by Insurance Enterprises

June 1982

Statement of Financial Accounting Standards No. 60

Accounting and Reporting by Insurance Enterprises

June 1982

INTRODUCTION

1. The primary purpose of insurance is to provide economic protection from identified risks occurring or discovered within a specified period. Some types of risks insured include death, disability, property damage, injury to others, and business interruption. Insurance transactions may be characterized generally by the following:

a. The purchaser of an insurance contract makes an initial payment or deposit to the insurance enterprise in advance of the possible occurrence or discovery of an insured event.
b. When the insurance contract is made, the insurance enterprise ordinarily does not know if, how much, or when amounts will be paid under the contract.

2. Two methods of premium revenue and contract liability recognition for insurance contracts have developed, which are referred to as short-duration and long-duration contract accounting in this Statement. Generally, the two methods reflect the nature of the insurance enterprise's obligations and policyholder rights under the provisions of the contract.

3. Premiums from short-duration insurance contracts, such as most property and liability insurance contracts, are intended to cover expected **claim**[1] costs resulting from insured events that occur during a fixed period of short duration. The insurance enterprise ordinarily has the ability to cancel the contract or to revise the premium at the beginning of each contract period to cover future insured events. Therefore, premiums from short-duration contracts ordinarily are earned and recognized as revenue evenly as insurance protection is provided.

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[1]Terms defined in the glossary (Appendix A) are in **boldface type** the first time they appear in this Statement.

4. Premiums from long-duration insurance contracts, including many life insurance contracts, generally are level even though the expected policy benefits and services do not occur evenly over the periods of the contracts. Functions and services provided by the insurer include insurance protection, sales, premium collection, claim payment, investment, and other services. Because no single function or service is predominant over the periods of most types of long-duration contracts, premiums are recognized as revenue over the premium-paying periods of the contracts when due from policyholders. Premium revenue from long-duration contracts generally exceeds expected policy benefits in the early years of the contracts and it is necessary to accrue, as premium revenue is recognized, a liability for costs that are expected to be paid in the later years of the contracts. Accordingly, a liability for expected costs relating to most types of long-duration contracts is accrued over the current and expected renewal periods of the contracts.

5. Title insurance contracts provide protection for an extended period and therefore are considered long-duration contracts. Premiums from title insurance contracts ordinarily are recognized as revenue on the effective date of the contract because most of the services associated with the contract have been rendered by that time. Estimated claim costs are recognized when premium revenue is recognized because the insurance provides protection against claims caused by problems with title to real estate arising out of ascertainable insured events that generally exist at that time.

APPLICABILITY AND SCOPE

6. This Statement establishes accounting and reporting standards for the general-purpose financial statements of stock **life insurance enterprises, property and liability insurance enterprises,**[2] and **title insurance enterprises.** Except

[2]Property and liability insurance enterprises, for purposes of this Statement, include stock enterprises, mutual enterprises, and **reciprocal or interinsurance exchanges.**

for the sections on premium revenue and claim cost recognition and **acquisition costs** (paragraphs 9-11, 13-18, and 20-31), this Statement applies to **mortgage guaranty insurance enterprises.** It does not apply to mutual life insurance enterprises, **assessment enterprises,** or **fraternal benefit societies.**

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

General Principles

7. Insurance contracts, for purposes of this Statement, shall be classified as short-duration or long-duration contracts depending on whether the contracts are expected to remain in force[3] for an extended period. The factors that shall be considered in determining whether a particular contract can be expected to remain in force for an extended period are:

a. *Short-duration contract.* The contract provides insurance protection for a fixed period of short duration and enables the insurer to cancel the contract or to adjust the provisions of the contract at the end of any contract period, such as adjusting the amount of premiums charged or coverage provided.
b. *Long-duration contract.* The contract generally is not subject to unilateral changes in its provisions, such as a noncancelable or guaranteed renewable contract, and requires the performance of various functions and services (including insurance protection) for an extended period.

8. Examples of short-duration contracts include most property and liability insurance contracts and certain **term life insurance** contracts, such as **credit life insurance.** Examples of long-duration contracts include **whole-life contracts,** guaranteed renewable term life contracts, **endowment contracts, annuity contracts,** and title insurance contracts. Accident

[3] *In force* refers to the period of coverage, that is, the period during which the occurrence of insured events can result in liabilities of the insurance enterprise.

and health insurance contracts may be short-duration or long-duration depending on whether the contracts are expected to remain in force for an extended period. For example, individual and **group insurance** contracts that are noncancelable or guaranteed renewable (renewable at the option of the insured), or collectively renewable (individual contracts within a group are not cancelable), ordinarily are long-duration contracts.

9. Premiums from short-duration insurance contracts ordinarily shall be recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided. A **liability for unpaid claims** (including estimates of costs for claims relating to insured events that have occurred but have not been reported to the insurer) and a **liability for claim adjustment expenses** shall be accrued when insured events occur.

10. Premiums from long-duration contracts shall be recognized as revenue when due from policyholders. A liability for expected costs relating to most types of long-duration contracts shall be accrued over the current and expected renewal periods of the contracts. The present value of estimated future policy benefits to be paid to or on behalf of policyholders less the present value of estimated future **net premiums** to be collected from policyholders (**liability for future policy benefits**) shall be accrued when premium revenue is recognized. Those estimates shall be based on assumptions, such as estimates of expected investment yields, **mortality, morbidity, terminations,** and expenses, applicable at the time the insurance contracts are made. In addition, liabilities for unpaid claims and claim adjustment expenses shall be accrued when insured events occur.

11. Costs that vary with and are primarily related to the acquisition of insurance contracts (acquisition costs) shall be capitalized and charged to expense in proportion to premium revenue recognized. Other costs incurred during the period, such as those relating to investments, general administration, and policy **maintenance,** shall be charged to expense as incurred.

12. Accounting for investments by insurance enterprises presumes that (a) insurance enterprises have both the ability and the intent to hold long-term investments, such as bonds, mortgage loans, and redeemable preferred stocks, to maturity and (b) there is no decline in the market value of the investments other than a temporary decline. Accordingly, bonds, mortgage loans, and redeemable preferred stocks shall be reported at amortized cost. Common and nonredeemable preferred stocks shall be reported at market, and real estate shall be reported at depreciated cost.

Premium Revenue Recognition

Short-Duration Contracts

13. Premiums from short-duration contracts ordinarily shall be recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided. For those few types of contracts for which the period of risk differs significantly from the contract period, premiums shall be recognized as revenue over the period of risk in proportion to the amount of insurance protection provided. That generally results in premiums being recognized as revenue evenly over the contract period (or the period of risk, if different), except for those few cases in which the amount of insurance protection declines according to a predetermined schedule.

14. If premiums are subject to adjustment (for example, retrospectively rated or other experience-rated insurance contracts for which the premium is determined after the period of the contract based on claim experience or reporting-form contracts for which the premium is adjusted after the period of the contract based on the value of insured property), premium revenue shall be recognized as follows:

a. If, as is usually the case, the ultimate premium is reasonably estimable, the estimated ultimate premium shall be recognized as revenue over the period of the contract. The estimated ultimate premium shall be revised to reflect current experience.
b. If the ultimate premium cannot be reasonably estimated,

the **cost recovery method** or the **deposit method** may be used until the ultimate premium becomes reasonably estimable.

Long-Duration Contracts

15. Premiums from long-duration contracts, such as whole-life contracts (including limited-payment and single-premium life contracts), guaranteed renewable term life contracts, endowment contracts, annuity contracts, and title insurance contracts, shall be recognized as revenue when due from policyholders.

16. Premiums from title insurance contracts shall be considered due from policyholders and, accordingly, recognized as revenue on the effective date of the insurance contract. However, the binder date (the date a commitment to issue a policy is given) is appropriate if the insurance enterprise is legally or contractually entitled to the premium on the binder date. If reasonably estimable, premium revenue and costs relating to title insurance contracts issued by agents shall be recognized when the agents are legally or contractually entitled to the premiums, using estimates based on past experience and other sources. If not reasonably estimable, premium revenue and costs shall be recognized when agents report the issuance of title insurance contracts.

Claim Cost Recognition

17. A liability for unpaid claim costs relating to insurance contracts other than title insurance contracts, including estimates of costs relating to **incurred but not reported claims,** shall be accrued when insured events occur. A liability for estimated claim costs relating to title insurance contracts, including estimates of costs relating to incurred but not reported claims, shall be accrued when title insurance premiums are recognized as revenue (paragraphs 15 and 16).

18. The liability for unpaid claims shall be based on the estimated ultimate cost of settling the claims (including the effects of inflation and other societal and economic factors),

using past experience adjusted for current trends, and any other factors that would modify past experience.[4] Changes in estimates of claim costs resulting from the continuous review process and differences between estimates and payments for claims shall be recognized in income of the period in which the estimates are changed or payments are made. Estimated recoveries on unsettled claims, such as **salvage, subrogation,** or a potential ownership interest in real estate, shall be evaluated in terms of their estimated realizable value and deducted from the liability for unpaid claims. Estimated recoveries on settled claims other than mortgage guaranty and title insurance claims also shall be deducted from the liability for unpaid claims.

19. Real estate acquired in settling mortgage guaranty and title insurance claims shall be reported at fair value, that is, the amount that reasonably could be expected to be received in a current sale between a willing buyer and a willing seller. If no market price is available, the expected cash flows (anticipated sales price less maintenance and selling costs of the real estate) may aid in estimating fair value provided the cash flows are discounted at a rate commensurate with the risk involved. Real estate acquired in settling claims shall be separately reported in the balance sheet and shall not be classified as an investment. Subsequent reductions in the reported amount and realized gains and losses on the sale of real estate acquired in settling claims shall be recognized as an adjustment to claim costs incurred.

20. A liability for all costs expected to be incurred in connection with the settlement of unpaid claims (**claim adjustment expenses**) shall be accrued when the related liability for unpaid claims is accrued. Claim adjustment expenses include costs associated directly with specific claims paid or in the process of settlement, such as legal and adjusters' fees. Claim adjustment expenses also include other costs that cannot be associated with specific claims but are related to claims paid or

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[4]Certain disclosures are required if the time value of money is considered in estimating liabilities for unpaid claims and claim adjustment expenses relating to short-duration contracts (paragraph 60(d)).

in the process of settlement, such as internal costs of the claims function.[5]

Liability for Future Policy Benefits

21. A liability for future policy benefits relating to long-duration contracts other than title insurance contracts (paragraph 17) shall be accrued when premium revenue is recognized. The liability, which represents the present value of future benefits to be paid to or on behalf of policyholders and related expenses less the present value of future net premiums (portion of **gross premium** required to provide for all benefits and expenses), shall be estimated using methods that include assumptions, such as estimates of expected investment yields, mortality, morbidity, terminations, and expenses, applicable at the time the insurance contracts are made. The liability also shall consider other assumptions relating to guaranteed contract benefits, such as coupons, annual endowments, and conversion privileges. The assumptions shall include provision for the **risk of adverse deviation.** Original assumptions shall continue to be used in subsequent accounting periods to determine changes in the liability for future policy benefits (often referred to as the "lock-in concept") unless a premium deficiency exists (paragraphs 35-37). Changes in the liability for future policy benefits that result from its periodic estimation for financial reporting purposes shall be recognized in income in the period in which the changes occur.

Investment Yields

22. Interest assumptions used in estimating the liability for future policy benefits shall be based on estimates of investment yields (net of related investment expenses) expected at the time insurance contracts are made. The interest assumption for each block of new insurance contracts (a group of

[5]Title insurance internal claim adjustment expenses, which generally consist of fixed costs associated with a permanent staff handling a variety of functions including claim adjustment, ordinarily are expensed as period costs because the costs are insignificant.

insurance contracts that may be limited to contracts issued under the same plan in a particular year) shall be consistent with circumstances, such as actual yields, trends in yields, portfolio mix and maturities, and the enterprise's general investment experience.

Mortality

23. Mortality assumptions used in estimating the liability for future policy benefits shall be based on estimates of expected mortality.

Morbidity

24. Morbidity assumptions used in estimating the liability for future policy benefits shall be based on estimates of expected incidences of disability and claim costs. Expected incidences of disability and claim costs for various types of insurance (for example, noncancelable and guaranteed renewable accident and health insurance contracts) and other factors, such as occupational class, waiting period, sex, age, and benefit period, shall be considered in making morbidity assumptions. The risk of antiselection (the tendency for lower terminations of poor risks) also shall be considered in making morbidity assumptions.

Terminations

25. Termination assumptions used in estimating the liability for future policy benefits shall be based on anticipated terminations and **nonforfeiture benefits,** using anticipated **termination rates** and contractual nonforfeiture benefits. Termination rates may vary by plan of insurance, age at issue, year of issue, frequency of premium payment, and other factors. If composite rates are used, the rates shall be representative of the enterprise's actual mix of business. Termination assumptions shall be made for long-duration insurance contracts without termination benefits because of the effects of terminations on anticipated premiums and claim costs.

Expenses

26. Expense assumptions used in estimating the liability for future policy benefits shall be based on estimates of expected nonlevel costs, such as termination or settlement costs, and costs after the premium-paying period. Renewal expense assumptions shall consider the possible effect of inflation on those expenses.

Costs Other Than Those Relating to Claims and Policy Benefits

27. Costs incurred during the period, such as those relating to investments, general administration, and policy maintenance, that do not vary with and are not primarily related to the acquisition of new and renewal insurance contracts shall be charged to expense as incurred.

Acquisition Costs

28. Acquisition costs are those costs that vary with and are primarily related to the acquisition of new and renewal insurance contracts. Commissions and other costs (for example, salaries of certain employees involved in the underwriting and policy issue functions, and medical and inspection fees) that are primarily related to insurance contracts issued or renewed during the period in which the costs are incurred shall be considered acquisition costs.

29. Acquisition costs shall be capitalized and charged to expense in proportion to premium revenue recognized. To associate acquisition costs with related premium revenue, acquisition costs shall be allocated by groupings of insurance contracts consistent with the enterprise's manner of acquiring, servicing, and measuring the profitability of its insurance contracts. Unamortized acquisition costs shall be classified as an asset.

30. If acquisition costs for short-duration contracts are determined based on a percentage relationship of costs incurred to premiums from contracts issued or renewed for a specified period, the percentage relationship and the period used, once

determined, shall be applied to applicable unearned premiums throughout the period of the contracts.

31. Actual acquisition costs for long-duration contracts shall be used in determining acquisition costs to be capitalized as long as gross premiums are sufficient to cover actual costs. However, estimated acquisition costs may be used if the difference is not significant. Capitalized acquisition costs shall be charged to expense using methods that include the same assumptions used in estimating the liability for future policy benefits.

Premium Deficiency

32. A probable loss on insurance contracts exists if there is a premium deficiency relating to short-duration or long-duration contracts. Insurance contracts shall be grouped consistent with the enterprise's manner of acquiring, servicing, and measuring the profitability of its insurance contracts to determine if a premium deficiency exists.

Short-Duration Contracts

33. A premium deficiency shall be recognized if the sum of expected claim costs and claim adjustment expenses, expected **dividends to policyholders,** unamortized acquisition costs, and maintenance costs exceeds related unearned premiums.[6]

34. A premium deficiency shall first be recognized by charging any unamortized acquisition costs to expense to the extent required to eliminate the deficiency. If the premium deficiency is greater than unamortized acquisition costs, a liability shall be accrued for the excess deficiency.

Long-Duration Contracts

35. Original policy benefit assumptions for long-duration con-

[6]Disclosure is required regarding whether the insurance enterprise considers anticipated investment income in determining if a premium deficiency relating to short-duration contracts exists (paragraph 60(e)).

tracts ordinarily continue to be used during the periods in which the liability for future policy benefits is accrued (paragraph 21). However, actual experience with respect to investment yields, mortality, morbidity, terminations, or expenses may indicate that existing contract liabilities, together with the present value of future gross premiums, will not be sufficient (a) to cover the present value of future benefits to be paid to or on behalf of policyholders and settlement and maintenance costs relating to a block of long-duration contracts and (b) to recover unamortized acquisition costs. In those circumstances, a premium deficiency shall be determined as follows:

Present value of future payments for benefits and related settlement and maintenance costs, determined using revised assumptions based on actual and anticipated experience	\$XX
Less the present value of future gross premiums, determined using revised assumptions based on actual and anticipated experience	XX
Liability for future policy benefits using revised assumptions	XX
Less the liability for future policy benefits at the valuation date, reduced by unamortized acquisition costs	XX
Premium deficiency	\$XX

36. A premium deficiency shall be recognized by a charge to income and (a) a reduction of unamortized acquisition costs or (b) an increase in the liability for future policy benefits. If a premium deficiency does occur, future changes in the liability shall be based on the revised assumptions. No loss shall be reported currently if it results in creating future income. The liability for future policy benefits using revised assumptions based on actual and anticipated experience shall be estimated periodically for comparison with the liability for future policy benefits (reduced by unamortized acquisition costs) at the valuation date.

37. A premium deficiency, at a minimum, shall be recognized if the aggregate liability on an entire line of business is deficient. In some instances, the liability on a particular line of business may not be deficient in the aggregate, but circumstances may be such that profits would be recognized in early years and losses in later years. In those situations, the liability shall be increased by an amount necessary to offset losses that would be recognized in later years.

Reinsurance

38. Amounts that are recoverable from reinsurers and that relate to paid claims and claim adjustment expenses shall be classified as assets, with an allowance for estimated uncollectible amounts. Estimated amounts recoverable from reinsurers that relate to the liabilities for unpaid claims and claim adjustment expenses shall be deducted from those liabilities. Ceded unearned premiums shall be netted with related unearned premiums. Receivables and payables from the same reinsurer, including amounts withheld, also shall be netted. **Reinsurance** premiums ceded and reinsurance recoveries on claims may be netted against related earned premiums and incurred claim costs in the income statement.

39. Proceeds from reinsurance transactions that represent recovery of acquisition costs shall reduce applicable unamortized acquisition costs in such a manner that net acquisition costs are capitalized and charged to expense in proportion to net revenue recognized (paragraph 29). If the ceding enterprise has agreed to service all of the related insurance contracts without reasonable compensation, a liability shall be accrued for estimated excess future servicing costs under the reinsurance contract. The net cost to the assuming enterprise shall be accounted for as an acquisition cost.

40. To the extent that a reinsurance contract does not, despite its form, provide for indemnification of the ceding enterprise by the reinsurer against loss or liability, the premium paid less the premium to be retained by the reinsurer shall be accounted for as a deposit by the ceding enterprise. Those contracts may be structured in various ways, but if, regardless of form, their substance is that all or part of the premium paid

by the ceding enterprise is a deposit, the amount paid shall be accounted for as such. A net credit resulting from the contract shall be reported as a liability by the ceding enterprise. A net charge resulting from the contract shall be reported as an asset by the reinsurer.

Policyholder Dividends

41. Policyholder dividends shall be accrued using an estimate of the amount to be paid.

42. If limitations exist on the amount of net income from **participating insurance** contracts of life insurance enterprises that may be distributed to stockholders, the policyholders' share of net income on those contracts that cannot be distributed to stockholders shall be excluded from stockholders' equity by a charge to operations and a credit to a liability relating to participating policyholders' funds in a manner similar to the accounting for net income applicable to minority interests. Dividends declared or paid to participating policyholders shall reduce that liability; dividends declared or paid in excess of the liability shall be charged to operations. Income-based dividend provisions shall be based on net income that includes adjustments between general-purpose and statutory financial statements that will reverse and enter into future calculations of the dividend provision.

43. For life insurance enterprises for which there are no net income restrictions and that use life insurance dividend scales unrelated to actual net income, policyholder dividends (based on dividends anticipated or intended in determining gross premiums or as shown in published dividend illustrations at the date insurance contracts are made) shall be accrued over the premium-paying periods of the contracts.

Retrospective and Contingent Commission Arrangements

44. If retrospective commission or experience refund arrangements exist under experience-rated insurance contracts, a separate liability shall be accrued for those amounts, based on experience and the provisions of the contract. Income in any

period shall not include any amounts that are expected to be paid to agents or others in the form of experience refunds or additional commissions. Contingent commissions receivable or payable shall be accrued over the period in which related income is recognized.

Investments

45. Bonds shall be reported at amortized cost if the insurance enterprise has both the ability and the intent to hold the bonds until maturity and there is no decline in the market value of the bonds other than a temporary decline. If an insurance enterprise is a trader in bonds and does not intend to hold the bonds until maturity, bonds shall be reported at market and temporary changes in the market value of the bonds shall be recognized as unrealized gains or losses (paragraph 50).

46. Common and nonredeemable preferred stocks shall be reported at market and temporary changes in the market value of those securities shall be recognized as unrealized gains or losses (paragraph 50). Preferred stocks that by their provisions must be redeemed by the issuer shall be reported at amortized cost if the insurance enterprise has both the ability and the intent to hold the stocks until redemption and there is no decline in the market value of the stocks other than a temporary decline.

47. Mortgage loans shall be reported at outstanding principal balances if acquired at par value, or at amortized cost if purchased at a discount or premium, with an allowance for estimated uncollectible amounts, if any. Amortization and other related charges or credits shall be charged or credited to investment income. Changes in the allowance for estimated uncollectible amounts relating to mortgage loans shall be included in realized gains and losses.

48. Real estate investments shall be reported at cost less accumulated depreciation and an allowance for any impairment in value. Depreciation and other related charges or credits shall be charged or credited to investment income. Changes in the allowance for any impairment in value relating to real estate investments shall be included in realized gains and losses.

49. Normal commitment fees received in connection with the placement of mortgage loans (less direct costs) shall be capitalized and recognized as revenue over the commitment period. Commitment fees that exceed current (normal) fees for mortgage loan commitments shall be considered an adjustment of the effective interest yield on the loan. Those excess fees shall be capitalized until the loan is made and then recognized as revenue over the period of the mortgage loan. If the mortgage loan is not ultimately made, the unamortized commitment fee shall be recognized as revenue at the end of the commitment period.

50. Realized gains and losses on all investments (including, but not limited to, stocks, bonds, mortgage loans, real estate, and joint ventures) shall be reported in the income statement below operating income and net of applicable income taxes. Realized gains and losses on the sale of assets other than investments, such as real estate used in the business, shall be reported in accordance with APB Opinion No. 30, *Reporting the Results of Operations.* Unrealized investment gains and losses, net of applicable income taxes, shall be reported as a separate component of stockholders' (policyholders') equity. Except as discussed in paragraph 51, unrealized gains or losses on common stocks, preferred stocks, or publicly traded bonds shall not be recognized in income until the sale, maturity, or other disposition of the investment.[7]

51. If a decline in the value of a common stock, preferred stock, or publicly traded bond below its cost or amortized cost is considered to be other than temporary, the investment shall be reduced to its net realizable value, which becomes the new cost basis. The amount of the reduction shall be reported as a realized loss. A recovery from the new cost basis shall be recognized as a realized gain only at the sale, maturity, or other disposition of the investment.

[7]This paragraph is not intended to preclude the accrual of losses on private-placement bonds when both conditions in paragraph 8 of FASB Statement No. 5, *Accounting for Contingencies,* are met.

Real Estate Used in the Business

52. Real estate shall be classified either as an investment or as real estate used in the enterprise's operations, depending on its predominant use. Depreciation and other real estate operating costs shall be classified as investment expenses or operating expenses consistent with the balance sheet classification of the related asset. Imputed investment income and rental expense shall not be recognized for real estate used in the business.

Separate Accounts

53. Separate accounts represent assets and liabilities that are maintained by an insurance enterprise for purposes of funding fixed-benefit or **variable annuity contracts,** pension plans, and similar activities. The contract holder generally assumes the investment risk, and the insurance enterprise receives a fee for investment management, certain administrative expenses, and mortality and expense risks assumed.

54. Investments in separate accounts shall be reported at market except for separate account contracts with guaranteed investment returns. For those separate accounts, the related assets shall be reported in accordance with paragraphs 45-51. Separate account assets and liabilities ordinarily shall be reported as summary totals in the financial statements of the insurance enterprise.

Income Taxes of Life Insurance Enterprises

Deferred Income Taxes

55. Because of the provisions of the Life Insurance Company

Income Tax Act of 1959 (Act),[8] timing differences (paragraph 13(e) of APB Opinion No. 11, *Accounting for Income Taxes*) of life insurance enterprises arising in the current period may not affect the determination of income taxes in future periods when those timing differences reverse. Amounts determined in the with-and-without calculation (paragraph 36 of Opinion 11) need to be considered further to determine whether the difference will reverse in the future. Deferred taxes need not be provided for the current tax effect of timing differences if circumstances indicate that the current tax effect will not reverse in the future. Similarly, a change in category of taxation (the basis on which the enterprise determines its income tax liability) resulting from the with-and-without calculation need not be recognized unless circumstances indicate that a change in category will result when the timing difference reverses. If the reversal of tax effects cannot be reasonably determined, deferred income taxes shall be provided based on the differential determined using the with-and-without calculation as if the enterprise's tax return was filed on the basis on which financial statements are prepared, including any resulting change in category of taxation.

56. Although (a) special deductions (allowable only for income tax purposes) never enter into the determination of pretax accounting income in any period and (b) the amount of policyholder dividend deductions and special deductions may

[8] The Act contemplated taxation of total income of life insurance enterprises, but the determination of tax is complex because of the manner in which total taxable income is classified as investment income, gain from operations (including investment income and less special deductions for certain accident and health, group life, and nonparticipating insurance contracts), policyholders' surplus (gain from operations previously excluded from tax and the special deductions), and the interrelationship of those elements. Taxable income consists of (a) taxable investment income, (b) 50 percent of the amount by which gain from operations exceeds taxable investment income, and (c) any reductions in policyholders' surplus. If gain from operations is less than taxable investment income, the lesser amount, plus any reductions in policyholders' surplus, is taxable income. If a loss from operations occurs, there is no taxable income except to the extent that there are reductions in policyholders' surplus. Deductions from gain from operations for policyholder dividends and the special deductions are limited and unused deductions cannot be carried forward to subsequent periods.

be limited on the tax return (the unused deductions cannot be carried forward to subsequent periods), the amount of policyholder dividend deductions and available special deductions and limitations on those deductions may properly be determined based on pretax accounting income. For example, unused policyholder dividend deductions and special deductions may be used to offset timing differences that affect taxable income to the extent that the limitations on those deductions change when based on pretax accounting income, unless known or anticipated circumstances indicate that future taxable income resulting from the reversal of timing differences will not be offset by like deductions. In the case of provisions for policyholder dividends (including policyholder dividends deducted as part of the change in the liability for future policy benefits), which may be timing differences themselves, statutory limitations shall not be applied to eliminate their current tax effect unless circumstances indicate that the dividends will be limited when the timing differences reverse. Special deductions that are directly affected by timing differences need to be redetermined in the with-and-without calculation unless circumstances indicate that future special deductions will not be directly affected by the timing differences when the timing differences reverse. If the reversal of tax effects cannot be reasonably determined, special deductions that are not affected by timing differences and, therefore, do not reverse shall be limited to amounts available in the tax return.

57. A life insurance enterprise's liability for future policy benefits and capitalization and amortization of acquisition costs indirectly affect the amount of taxable investment income used in determining the income tax provision for financial reporting purposes. Differences in taxable investment income caused by differences between the liability for future policy benefits and capitalization and amortization of acquisition costs for income tax and financial reporting purposes shall be considered permanent differences (paragraph 13(f) of Opinion 11).

58. If deferred income taxes have not been provided on timing differences on the presumption that the timing differences will not have tax effects when they reverse and circumstances

change so that it becomes apparent that tax effects will result, deferred income taxes attributable to those timing differences shall be accrued and reported as income tax expense in that period; those income taxes shall not be reported as an extraordinary item. If deferred income taxes have been provided on timing differences and circumstances change so that it becomes apparent that the tax effects will differ from those originally expected, income taxes previously deferred shall be included in income only as the related timing differences reverse, regardless of whether the life insurance enterprise uses the gross change or net change method (paragraph 37 of Opinion 11).

Policyholders' Surplus

59. A difference between taxable income and pretax accounting income attributable to amounts designated as policyholders' surplus of a life insurance enterprise may not reverse until indefinite future periods or may never reverse. The insurance enterprise controls the events that create the tax consequences, and the enterprise generally is required to take specific action before the initial difference reverses. Therefore, a life insurance enterprise shall not accrue income taxes on the difference between taxable income and pretax accounting income attributable to amounts designated as policyholders' surplus. However, if circumstances indicate that the insurance enterprise is likely to pay income taxes, either currently or in later years, because of a known or expected reduction in policyholders' surplus, income taxes attributable to that reduction shall be accrued as a tax expense of the current period; the accrual of those income taxes shall not be accounted for as an extraordinary item.

Disclosures

60. Insurance enterprises shall disclose the following in their financial statements:

a. The basis for estimating the liabilities for unpaid claims and claim adjustment expenses
b. The methods and assumptions used in estimating the lia-

bility for future policy benefits with disclosure of the average rate of assumed investment yields in effect for the current year encouraged

c. The nature of acquisition costs capitalized, the method of amortizing those costs, and the amount of those costs amortized for the period
d. The carrying amount of liabilities for unpaid claims and claim adjustment expenses relating to short-duration contracts that are presented at present value in the financial statements and the range of interest rates used to discount those liabilities
e. Whether the insurance enterprise considers anticipated investment income in determining if a premium deficiency relating to short-duration contracts exists
f. The nature and significance of reinsurance transactions to the insurance enterprise's operations, including reinsurance premiums assumed and ceded, and estimated amounts that are recoverable from reinsurers and that reduce the liabilities for unpaid claims and claim adjustment expenses
g. The relative percentage of participating insurance, the method of accounting for policyholder dividends, the amount of dividends, and the amount of any additional income allocated to participating policyholders
h. The following information relating to stockholders' equity, statutory capital and surplus, and the effects of **statutory accounting practices** on the enterprise's ability to pay dividends to stockholders:
   (1) The amount of statutory capital and surplus
   (2) The amount of statutory capital and surplus necessary to satisfy regulatory requirements (based on the enterprise's current operations) if significant in relation to the enterprise's statutory capital and surplus
   (3) The nature of statutory restrictions on the payment of dividends and the amount of retained earnings that is not available for the payment of dividends to stockholders
i. For life insurance enterprises or a parent of a life insurance enterprise that is either consolidated or accounted for by the equity method:
   (1) The treatment of policyholders' surplus under the U.S. Internal Revenue Code and that income taxes

may be payable if the enterprise takes certain specified actions, which shall be appropriately described

(2) The accumulated amount of policyholders' surplus for which income taxes have not been accrued

j. For life insurance enterprises, any retained earnings in excess of policyholders' surplus on which no current or deferred federal income tax provisions have been made and the reasons for not providing the deferred taxes

Amendments to Other Pronouncements

61. The following footnote is added to the end of paragraph 6 of Opinion 11:

> For life insurance enterprises, also refer to paragraphs 55-59 and subparagraphs 60(i) and 60(j) of FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises.*

62. The provisions of APB Opinion No. 23, *Accounting for Income Taxes—Special Areas,* that discuss policyholders' surplus of life insurance enterprises have been included in this Statement without reconsideration, and paragraphs 26-30 and footnote 11 of Opinion 23 are superseded by this Statement.

63. The references to AICPA insurance industry related Guides in footnote 8 of Opinion 30, paragraphs 41 and 102 of FASB Statement No. 5, *Accounting for Contingencies,* paragraph 4 of FASB Interpretation No. 15, *Translation of Unamortized Policy Acquisition Costs by a Stock Life Insurance Company,* and paragraph 7 of FASB Interpretation No. 22, *Applicability of Indefinite Reversal Criteria to Timing Differences,* are replaced by a reference to FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises.* The references to AICPA Statements of Position (SOPs) 78-6, *Accounting for Property and Liability Insurance Companies,* and 79-3, *Accounting for Investments of Stock Life Insurance Companies,* and to the AICPA Industry Audit Guides, *Audits of Fire and Casualty Insurance Companies* and *Audits of Stock Life Insurance Companies,* are deleted from Appendix A of FASB State-

ment No. 32, *Specialized Accounting and Reporting Principles and Practices in AICPA Statements of Position and Guides on Accounting and Auditing Matters.* The reference to the AICPA project on accounting by title insurance companies, which resulted in the issuance of SOP 80-1, *Accounting for Title Insurance Companies,* is deleted from Appendix B of Statement 32.

Effective Date and Transition

64. This Statement shall be effective for fiscal years beginning after December 15, 1982, with earlier application encouraged. Accounting changes adopted to conform to the provisions of this Statement shall be applied retroactively. In the year that this Statement is first applied, the financial statements shall disclose the nature of any restatement and its effect on income before extraordinary items, net income, and related per share amounts for each year presented. The individual effects of changing to conform to the provisions of this Statement shall be disclosed in the financial statements.

65. If retroactive restatement of all years presented is not practicable, the financial statements presented shall be restated for as many consecutive years as practicable and the cumulative effect of applying this Statement shall be included in determining net income of the earliest year restated (not necessarily the earliest year presented). If it is not practicable to restate any prior year, the cumulative effect shall be included in net income in the year in which this Statement is first applied. (Refer to paragraph 20 of APB Opinion No. 20, *Accounting Changes.*)

The provisions of this Statement need not be applied to immaterial items.

This Statement was approved by the unanimous vote of the seven members of the Financial Accounting Standards Board:

Donald J. Kirk, *Chairman*
Frank E. Block
John W. March
Robert A. Morgan
David Mosso
Robert T. Sprouse
Ralph E. Walters

Appendix A

GLOSSARY

66. This appendix defines certain terms that are used in this Statement.

Acquisition costs

Costs incurred in the acquisition of new and renewal insurance contracts. Acquisition costs include those costs that vary with and are primarily related to the acquisition of insurance contracts (for example, agent and broker commissions, certain underwriting and policy issue costs, and medical and inspection fees).

Annuity contract

A contract that provides fixed or variable periodic payments made from a stated or contingent date and continuing for a specified period, such as for a number of years or for life. Also refer to variable annuity contract.

Assessment enterprise

An insurance enterprise that sells insurance to groups with similar interests, such as church denominations or professional groups. Some assessment enterprises also sell insurance directly to the general public. If funds are not sufficient to pay claims, then assessments may be made against members.

Claim

A demand for payment of a policy benefit because of the occurrence of an insured event, such as the death or disability of the insured; the maturity of an endowment; the incurrence of hospital or medical bills; the destruction or damage of property and related deaths or injuries; defects in, liens on, or challenges to the title to real estate; or the occurrence of a surety loss.

Claim adjustment expenses

Expenses incurred in the course of investigating and settling claims. Claim adjustment expenses include any legal and adjusters' fees, and the costs of paying claims and all related expenses.

Cost recovery method

Under the cost recovery method, premiums are recognized as revenue in an amount equal to estimated claim costs as insured events occur until the ultimate premium is reasonably estimable, and recognition of income is postponed until that time.

Credit life insurance

Life insurance, generally in the form of decreasing term insurance, that is issued on the lives of borrowers to cover payment of loan balances in case of death.

Deposit method

Under the deposit method, premiums are not recognized as revenue and claim costs are not charged to expense until the ultimate premium is reasonably estimable, and recognition of income is postponed until that time.

Dividends to policyholders

Amounts distributable to policyholders of participating insurance contracts as determined by the insurer. Under various state insurance laws, dividends are apportioned to policyholders on an equitable basis. The dividend allotted to any contract often is based on the amount that the contract, as one of a class of similar contracts, has contributed to the income available for distribution as dividends.

Endowment contract

An insurance contract that provides insurance from inception of the contract to the maturity date (endowment period). The contract specifies that a stated amount, adjusted for items such as policy loans and dividends, if any, will be paid to the beneficiary if the insured dies before the maturity date. If the insured is still living at the maturity date, the policyholder will receive the maturity amount under the contract after adjustments, if any. Endowment contracts generally mature at a specified age of the insured or at the end of a specified period.

Fraternal benefit society

An organization that provides life or health insurance to its members and their beneficiaries. Policyholders normally participate in the earnings of the society, and insurance contracts stipulate that the society has the power to assess its members if the funds available for future policy benefits are not sufficient to provide for benefits and expenses.

Gross premium

The premium charged to a policyholder for an insurance contract. Also refer to net premium.

Group insurance

Insurance protecting a group of persons, usually employees of an entity and their dependents. A single insurance contract is issued to their employer or other representative of the group. Individual certificates often are given to each insured individual or family unit. The insurance usually has an annual renewable contract period, although the insurer may guarantee premium rates for two or three years. Adjustments to premiums relating to the actual experience of the group of insured persons are common.

Incurred but not reported claims

Claims relating to insured events that have occurred but have not yet been reported to the insurer or reinsurer as of the date of the financial statements.

Liability for claim adjustment expenses

The amount needed to provide for the estimated ultimate cost required to investigate and settle claims relating to insured events that have occurred on or before a particular date (ordinarily, the balance sheet date), whether or not reported to the insurer at that date.

Liability for future policy benefits

An accrued obligation to policyholders that relates to insured events, such as death or disability. The liability for future policy benefits can be viewed as either (a) the present value of future benefits to be paid to or on behalf of policyholders and expenses less the present value of future net premiums payable under the insurance contracts or (b) the accumulated amount of net premiums already collected less the accumulated amount of benefits and expenses already paid to or on behalf of policyholders.

Liability for unpaid claims

The amount needed to provide for the estimated ultimate cost of settling claims relating to insured events that have occurred on or before a particular date (ordinarily, the balance sheet date). The estimated liability includes the amount of money that will be required for future payments on both (a) claims that have been reported to the insurer and (b) claims relating to insured events that have occurred but have not been reported to the insurer as of the date the liability is estimated.

Life insurance enterprise

An enterprise that can issue annuity, endowment, and accident and health insurance contracts as well as life insurance contracts. Life insurance enterprises may be either stock or mutual organizations.

Maintenance costs

Costs associated with maintaining records relating to insurance contracts and with the processing of premium collections and commissions.

Morbidity

The relative incidence of disability due to disease or physical impairment.

Mortality

The relative incidence of death in a given time or place.

Mortgage guaranty insurance enterprise

An insurance enterprise that issues insurance contracts that guarantee lenders, such as savings and loan associations, against nonpayment by mortgagors.

Net premium

As used in this Statement for long-duration insurance contracts, the portion of the gross premium required to provide for all benefits and expenses.

Nonforfeiture benefits

Those benefits in a life insurance contract that the policyholder does not forfeit, even for failure to pay premiums. Nonforfeiture benefits usually include cash value, paid-up insurance value, or extended-term insurance value.

Participating insurance

Insurance in which the policyholder is entitled to participate in the earnings or surplus of the insurance enterprise. The participation occurs through the distribution of dividends to policyholders.

Property and liability insurance enterprise

An enterprise that issues insurance contracts providing protection against (a) damage to, or loss of, property caused by various perils, such as fire and theft, or (b) legal liability resulting from injuries to other persons or damage to their property. Property and liability insurance enterprises also can issue accident and health insurance contracts. The term *property and liability insurance enterprise* is the current terminology used to describe a fire and casualty insurance enterprise. Property and liability insurance enterprises may be either stock or mutual organizations.

Reciprocal or interinsurance exchange

A group of persons, firms, or corporations commonly referred to as "subscribers" that exchange insurance contracts through an attorney-in-fact (an attorney authorized by a person to act in that person's behalf).

Reinsurance

A transaction in which a reinsurer (assuming enterprise), for a consideration (premium), assumes all or part of a risk undertaken originally by another insurer (ceding enterprise). However, the legal rights of the insured are not affected by the reinsurance transaction and the insurance enterprise issuing the insurance contract remains liable to the insured for payment of policy benefits.

Risk of adverse deviation

A concept used by life insurance enterprises in estimating the liability for future policy benefits relating to long-duration contracts. The risk of adverse deviation allows for possible unfavorable deviations from assumptions, such as estimates of expected investment yields, mortality, morbidity, terminations, and expenses. The concept is referred to as *risk load* when used by property and liability insurance enterprises.

Salvage

The amount received by an insurer from the sale of property (usually damaged) on which the insurer has paid a total claim to the insured and has obtained title to the property.

Statutory accounting practices

Accounting principles required by statute, regulation, or rule, or permitted by specific approval, that an insurance enterprise is required to follow when submitting its financial statements to state insurance departments.

Subrogation

The right of an insurer to pursue any course of recovery of damages, in its name or in the name of the policyholder, against a third party who is liable for costs relating to an insured event that have been paid by the insurer.

Term life insurance

Insurance that provides a benefit if the insured dies within the period specified in the contract. The insurance is for level or declining amounts for stated periods, such as 1, 5, or 10 years, or to a stated age. Term life insurance generally has no loan or cash value.

Termination

In general, the failure to renew an insurance contract. Involuntary terminations include death, expirations, and maturities of contracts. Voluntary terminations of life insurance contracts include lapses with or without cash surrender value and contract modifications that reduce paid-up whole-life benefits or term-life benefits.

Termination rate

The rate at which insurance contracts fail to renew. Termination rates usually are expressed as a ratio of the number of contracts on which insureds failed to pay premiums during a given period to the total number of contracts at the beginning of the period from which those terminations occurred. The complement of the termination rate is persistency, which is the renewal quality of insurance contracts, that is, the number of insureds that keep their insurance in force during a period. Persistency varies by plan of insurance, age at issue, year of issue, frequency of premium payment, and other factors.

Title insurance enterprise

An enterprise that issues title insurance contracts to real estate owners, purchasers, and mortgage lenders, indemnifying them against loss or damage arising out of defects in, liens on, or challenges to their title to real estate.

Variable annuity contract

An annuity in which the amount of payments to be made are specified in units, rather than in dollars. When payment is due, the amount is determined based on the value of the investments in the annuity fund.

Whole-life contract

Insurance that may be kept in force for a person's entire life by paying one or more premiums. It is paid for in one of three different ways: (a) ordinary life insurance (premiums are payable as long as the insured lives), (b) limited-payment life insurance (premiums are payable over a specified number of years), and (c) single-premium life insurance (a lump-sum amount paid at the inception of the insurance contract). The insurance contract pays a benefit (contractual amount adjusted for items such as policy loans and dividends, if any) at the death of the insured. Whole-life insurance contracts also build up non-forfeiture benefits.

Appendix B

BACKGROUND INFORMATION AND SUMMARY OF CONSIDERATION OF COMMENTS ON EXPOSURE DRAFT

67. As discussed in Statement 32, the FASB is extracting the specialized[9] accounting and reporting principles and practices from AICPA SOPs and Guides on accounting and auditing matters and issuing them as FASB Statements after appropriate due process. This Statement extracts without significant change the specialized principles and practices relating to insurance enterprises from the AICPA Industry Audit Guides, *Audits of Stock Life Insurance Companies* and *Audits of Fire and Casualty Insurance Companies;* AICPA SOPs 78-6, 79-3, and 80-1; and Opinion 23. Accounting and reporting standards that apply to enterprises in general also apply to insurance enterprises, and the standards in this Statement are in addition to those standards.

68. Board members have assented to the issuance of this Statement on the basis that it is an appropriate extraction of existing specialized principles and practices and that a comprehensive reconsideration of those principles and practices was not contemplated in undertaking this FASB project. Most of the background material and discussion of accounting alternatives have not been carried forward from the AICPA insurance industry related Guides and SOPs. The Board's conceptual framework project on accounting recognition criteria will address recognition issues relating to elements of financial statements. A Statement of Financial Accounting Concepts resulting from that project in due course will serve as a basis for evaluating existing standards and practices. Accordingly, the Board may wish to evaluate the standards in this Statement when its conceptual framework project is completed.

[9]The term *specialized* is used to refer to those accounting and reporting principles and practices in AICPA Guides and SOPs that are neither superseded by nor contained in Accounting Research Bulletins, APB Opinions, FASB Statements, or FASB Interpretations.

69. This Statement does not address issues that currently are being studied by the insurance industry and the accounting and actuarial professions. Some of those issues include:

a. What financial accounting and reporting principles should mutual life insurance enterprises, assessment enterprises, and fraternal benefit societies follow in their general-purpose financial statements?
b. How should universal life insurance contracts and similar products that have been developed since the AICPA insurance industry related Guides and SOPs were originally issued be accounted for?
c. For short-duration contracts:
   (1) Should certain claim liabilities be discounted?
   (2) Should anticipated investment income be considered in determining if a premium deficiency exists?
d. What circumstances constitute a transfer of economic risk under a reinsurance contract?

70. An Exposure Draft of a proposed FASB Statement, *Accounting and Reporting by Insurance Enterprises,* was issued on November 18, 1981. The Board received 56 comment letters in response to the Exposure Draft. Certain of the comments received and the Board's consideration of them are discussed in this appendix.

Criteria for Distinguishing between Short-Duration and Long-Duration Contracts

71. Respondents commented on the appropriateness of the proposed criteria for distinguishing between short-duration and long-duration contracts and on whether the criteria could be improved. Some respondents said that the criteria were not well defined and could result in unintended changes in current accounting principles or practices because the criteria focused too narrowly on whether an insurance contract can be expected to remain in force for an extended period. They suggested that the criteria be clarified so that the nature of the insurance enterprise's obligations and policyholder rights under the provisions of the contract is considered.

72. Other respondents recommended that (a) accounting for insurance contracts should depend on the type of insurance enterprise issuing the contract, (b) the criteria for distinguishing between the two types of contracts should be based on the period of the contract, or (c) contracts should be specified by type of insurance protection that should be considered short-duration or long-duration so that the Statement can be specifically applied without exception or ambiguity.

73. In extracting the specialized principles and practices from the AICPA insurance industry related Guides and SOPs, the Board decided to establish a framework for accounting by insurance enterprises based on the nature of insurance contracts rather than type of insurance enterprise. The Board concluded that the criteria for distinguishing between short-duration and long-duration contracts should be clarified so that the nature of the insurance enterprise's obligations and policyholder rights under the provisions of the contract is considered, because that is consistent with (a) a general framework, (b) the principles in the AICPA insurance industry related Guides and SOPs, and (c) current practice.

Impairment in Value of Publicly Traded Securities

74. If an investment in a publicly traded security is reduced to its net realizable value, paragraph 51 requires that a gain not be recognized until the sale, maturity, or other disposition of the investment. Some respondents argued that permanent impairment is too absolute and often cannot be determined until after the event causing the impairment has occurred. In addition, they said that accounting for impaired amounts relating to publicly traded securities should be consistent with accounting for mortgage loans and real estate investments and reflective of an insurance enterprise's estimate of its ability to recover the carrying amount of those securities. They suggested that a standard consistent with Statement 5 be included to require adjustments of the carrying amount as circumstances change.

75. Other respondents agreed with paragraph 51 because it is an accurate extraction of SOPs 78-6, 79-3, and 80-1 and is con-

sistent with principles and practices applicable to enterprises in other industries. Based on that reasoning, the Board concluded that adjustments for increases in value of previously impaired publicly traded securities should continue to be proscribed.

Acquisition Costs: Primarily versus Directly Related

76. Some respondents commented on the definition in paragraph 28 that states that acquisition costs are those costs that vary with and are *primarily* related to the acquisition of new and renewal insurance contracts. They pointed out that, while the term *primarily* currently is used in practice by life insurance enterprises, the term *directly* is used in practice by property and liability insurance enterprises. They said that using the term *primarily* for all insurance enterprises could produce a different result for property and liability insurance enterprises. They recommended that the distinction between *primarily* and *directly* be retained in prescribing accounting principles for acquisition costs.

77. The Board believes that accounting principles and practices should not be applied differently among insurance enterprises without differences in underlying circumstances. Because the term *primarily* encompasses *directly,* the Board acknowledges that use of the term *primarily* might allow property and liability insurance enterprises to adopt broader guidelines in defining acquisition costs that are capitalizable. However, the Board believes that the use of the term *primarily* should not cause insurance enterprises to change their methods of defining acquisition costs to be capitalized.

Disclosure of the Average Rate of Assumed Investment Yields

78. Respondents commented on the benefits and costs of specifically requiring a disclosure of the average rate of assumed investment yields used in estimating the liability for future policy benefits. Some respondents said that disclosure of the average rate of assumed investment yields should be required because the disclosure would be relevant to users in assessing the reasonableness of estimated rates of return in relation to

current investment yields and in comparing insurance enterprises. They also expressed the view that the cost to the reporting enterprise would be minimal and that the benefit to users of insurance enterprise financial statements would outweigh the related cost.

79. Other respondents said it is likely that the development of a single average interest rate would involve a time-consuming and costly process that would not be justified by the benefit. They also argued that the weighted average of interest rate assumptions has little meaning when there are other significant assumptions that also must be considered in estimating the liability for future policy benefits and that the disclosure would likely result in a general perception that the rate possessed more significance and value than deserved.

80. The Board agrees with those respondents that said disclosure of the average rate of assumed investment yields is useful in assessing the reasonableness of estimated rates of return in relation to current investment yields and in comparing insurance enterprises. However, because of uncertainties relating to the cost of providing that disclosure, the Board decided to encourage but not require disclosure of that yield rate.

Disclosure of Discounting Short-Duration Contract Claim Liabilities and Considering Anticipated Investment Income in Determining Premium Deficiencies

81. The Exposure Draft would have required disclosure of (a) the effects (including amounts) of discounting short-duration contract claim liabilities and (b) the effects (including amounts) of an enterprise's considering anticipated investment income in determining if a premium deficiency relating to short-duration contracts exists. Some respondents said that insurance enterprises generally are not disclosing *amounts* in their notes because they believe disclosure of amounts is not required in the AICPA insurance industry related Guides and SOPs, which require disclosure of only the *effects*. Other respondents recommended that the Exposure Draft be revised to require disclosure of the carrying amount of claim liabilities

carried at present value in the balance sheet, the range of interest rates used to discount the claim liabilities, and the period of years over which the claims are being paid.

82. The phrase *including amounts* was included in the Exposure Draft to clarify what the Board understands was meant by *effects on the financial statements* in SOP 78-6. The Board believes that quantitative disclosures relating to the discounting of short-duration claim liabilities is necessary and, accordingly, decided to require disclosure of the carrying amount of short-duration contract liabilities that are presented at present value and the range of discount rates. However, the Board agreed that disclosure of amounts relating to an insurance enterprise's consideration of anticipated investment income in determining whether a premium deficiency exists is not necessary, and decided to require disclosure of only whether the insurance enterprise considers anticipated investment income in making that determination.

Disclosure of Statutory Requirements

83. With respect to the proposed disclosure of information relating to statutory capital and surplus requirements, some respondents suggested that disclosure be limited to the amount of statutory capital and surplus, minimum statutory requirements when significant, and statutory limitations on the payment of dividends. Other respondents recommended that the proposed disclosures parallel those in the SEC's recent revision of Article 7 of Regulation S-X. The Board agreed that the disclosure relating to statutory requirements needed clarification and revised the disclosure in accordance with the first sentence of this paragraph.

Reconciliation Disclosure

84. Respondents commented on whether disclosure of a reconciliation between financial reporting and statutory capital and income should be required. Some respondents said the disclosure should be required because the differences between statutory accounting practices and generally accepted accounting principles are an important element in the analysis

of an insurance enterprise's general-purpose financial statements. They pointed out that statutory accounting determines the amount of dividends that can be paid as well as the sufficiency of statutory capital and surplus for regulatory purposes and, therefore, is important to users of insurance enterprise financial statements.

85. Other respondents said the reconciliation disclosure should not be required because the original purpose of the reconciliation was intended principally to provide relevant information during the life insurance industry's transition from statutory reporting. They also said that the disclosure may cast doubt on the appropriateness of accounting principles used in the general-purpose financial statements.

86. The Board believes that the disclosure in paragraph 60(h) relating to statutory requirements is sufficient for the general-purpose financial statements of insurance enterprises.

Other Comments

87. Some respondents noted that paragraph 10 of the Exposure Draft would require a liability for claim adjustment expenses to be accrued when insured events occur and that life insurance enterprises currently are not accruing those costs. They said that accruing claim adjustment expenses associated with unpaid claims would require an accounting change for life insurance enterprises and that, although it may be appropriate to require life insurance enterprises to accrue a liability for those costs, those enterprises should be excluded from that requirement since the AICPA stock life insurance guide does not require that accrual. However, they acknowledged that the change is not likely to significantly affect the financial statements of life insurance enterprises. The Board believes that the requirement is appropriate and that it meets a criterion for change—that is, practices among insurance enterprises are different without differences in circumstances. In addition, the Board believes the requirement is consistent with the provisions of Statement 5.

88. Several respondents suggested various substantive changes to the Exposure Draft. Adoption of those suggestions would have required a reconsideration of some of the provisions of the Guides and SOPs. Such a reconsideration is not contemplated in the extraction project unless a proposed change meets one of the three criteria for change included in the "Notice for Recipients" of the Exposure Draft or is broadly supported. The proposed changes did not meet the criteria for change and were not broadly supported. Accordingly, the Board did not adopt those suggestions. However, based on suggestions from respondents to the Exposure Draft, the Board has made several other changes that it believes clarify the Statement.

89. The Board has concluded that it can reach an informed decision on the basis of existing information without a public hearing and that the effective date and transition specified in paragraphs 64 and 65 are advisable in the circumstances.

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